Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

October Term, 1995

MONTGOMERY SECURITIES and
PAINEWEBBER INC.,

Petitioners,

v.

RICHARD B. DANNENBERG, MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, trustees of William J. Bing and Arlene S. Bing Living Trust, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, and JACK SCHNITZER, On Behalf of Themselves and all others Similarly Situated,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED

1. Is recklessness sufficient to satisfy the scienter requirement of Section 10(b) of the Securities Exchange Act of 1934, and, if so, is it necessary to show at least subjective (i.e., conscious) recklessness?

2. Under Section 11 and Section 12(2) of the Securities Act of 1933, does the fact that information is "material" create an affirmative duty of disclosure, even though the information does not render misleading any statement in the prospectus or registration statement?

OTHER PARTIES

In addition to petitioners, Deloitte & Touche also appeared as a defendant-appellee before the Ninth Circuit below.

DISCLOSURE PURSUANT TO RULE 29.1

Petitioner Montgomery Securities is a limited partnership.

Petitioner PaineWebber Incorporated identifies its corporate parent as PaineWebber Group, Inc., whose shares are publicly traded. PaineWebber Incorporated has no subsidiaries other than wholly-owned subsidiaries.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit, affirming in part and reversing in part the district court's grant of summary judgment for petitioners, is reported at 50 F.3d 615, and is reprinted as Appendix A, at A1. (References to the appendices bound with this Petition are styled ("A "). The opinion of the United States District Court for the Northern District of California, from which appeal was taken, is reported at 789 F. Supp. 1489 and reprinted as Appendix B, at A25).

JURISDICTION

The decision of the court of appeals issued on October 19, 1994, and was amended on March 13, 1995. A timely petition for rehearing and suggestion for rehearing *en banc* was denied on March 13, 1995, upon the issuance of the amended opinion. (A1). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case presents questions of statutory interpretation involving Sections 11 and 12(2) of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77l(2) (1988), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5. These statutory provisions are reprinted in full in Appendix C, at A68.

STATEMENT OF THE CASE

I. Proceedings in the District Court

In July 1990, Software Toolworks, Inc. ("Toolworks") conducted a secondary stock offering that is the subject of this suit. Defendants Montgomery Securities and

PaineWebber Incorporated ("the Underwriters") were the Underwriters for the offering, and defendant Deloitte & Touche ("Deloitte") was the auditor. The registration statement, which went effective on July 10, 1990, contained financial statements for Toolworks through its March 1990 quarter. Results for the June quarter were not included or mentioned in the registration statement or the prospectus. A month after the offering, on August 14, Toolworks announced its results for the June quarter; they were in line with Wall Street's expectations.

On October 10, 1990, Toolworks announced that it would report substantial losses for the September quarter. The company also reversed certain sales that had been included in the August announcement of June quarter revenues. The company's stock dropped from $5.38 to $2.38. The next day plaintiffs filed a securities fraud class action against Toolworks, its officers, the Underwriters, and Deloitte. Toolworks and the officer defendants settled quickly, but the case continued against the Underwriters and Deloitte. Discovery was protracted, with plaintiffs taking more than 60 depositions. The Underwriters and Deloitte then moved for summary judgment on plaintiffs' Section 10(b)[1] and Section 11[2] claims. The Underwriters also moved for summary judgment on plaintiffs' Section 12(2)[3] claim.

In a lengthy and thoughtful opinion, the district court granted the Underwriters' motion in its entirety. With respect to plaintiffs' Section 11 and Section 12(2) claims, the district court found that the Underwriters' investigation of matters covered in the prospectus and registration statement had been "reasonable under the circumstances" and there-

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[1]Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5.

[2]Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k.

[3]Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2).

fore established their due diligence defense. (A33). The district court also rejected plaintiffs' Section 10(b) claim that the investigation was so deficient as to amount to "recklessness" under *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991). The district court noted that the Underwriters' overall course of conduct was inconsistent with scienter: not only did the Underwriters carry out a thorough investigation of all aspects of Toolworks, but they also required extensive risk warnings in the prospectus and disclosed negative facts that they knew of or suspected. (A38-A41 & A38 n.16).

In view of this course of conduct, the district court concluded that no jury reasonably could find that the Underwriters had acted recklessly. With respect to plaintiffs' claim that the Underwriters "should have been suspicious" of Toolworks and its counsel concerning the June quarter results, the district court observed: " 'Should have' . . . is not the standard." The few facts pointed to by plaintiffs were not sufficient to give rise to an inference of recklessness. (A41). Whatever the Underwriters ostensibly "should have" known, the district court held, there was insufficient evidence from which a reasonable jury could conclude that the Underwriters had anything other than an honest belief in the representations made to them. (A41).

II. Proceedings in the Court of Appeals

The Ninth Circuit affirmed in part and reversed in part.[4] With respect to plaintiffs' Section 11 and Section 12(2) claims against the Underwriters, the Ninth Circuit concluded that the test for due diligence under both provisions

[4]The Court of Appeals initially dismissed plaintiffs' appeal for lack of a final judgment. *See Dannenberg v. Software Toolworks, Inc.*, 16 F.3d 1073 (9th Cir. 1994). After plaintiffs obtained Rule 54(b) certification from the district court, the Court of Appeals considered the matter on the merits. (A3).

"is, in effect, a negligence standard." (A5) (quotation omitted). The Ninth Circuit affirmed the district court's conclusion that the Underwriters had properly investigated all matters discussed in the prospectus.

The Ninth Circuit nevertheless concluded that there was a triable issue as to the Underwriters' Section 11 and Section 12(2) liability regarding two matters in the June quarter, while the registration statement was pending with the Securities and Exchange Commission.[5] The court did not identify any statement in the prospectus or registration statement that related to the June quarter. Nevertheless, the court concluded that because the June results may have been material, their omission potentially rendered the prospectus and registration statement misleading. *See* A13 n.2.

The Ninth Circuit pointed to two aspects of the Underwriters' June quarter diligence that may have been inadequate. First, the court held that the Underwriters may not have exercised due care with respect to a letter sent by Toolworks' counsel to the SEC on Toolworks' behalf in early July. In this letter, which was not part of the prospectus or registration statement, Toolworks stated that it did not have preliminary results for the quarter. (A14). The Ninth Circuit did not identify any evidence that would have given the Underwriters reason to suspect that preliminary numbers in fact were available, when Toolworks and its counsel said that they were not. Moreover, the court found that "the plaintiffs presented no evidence of the Underwriters' actual knowledge" of these preliminary figures. (A18). The Ninth Circuit nonetheless concluded that the Underwriters "had access" to information that would have shown the SEC letter to be false, because the Underwriters had participated in a conference call about the letter. (A15).

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[5]Toolworks' preliminary registration statement was filed with the SEC on June 8, 1990, but did not become effective until July 10, 1990.

The Ninth Circuit also concluded that a jury should decide whether the failure to uncover three large consignment orders booked as sales by Toolworks at the end of June rendered the Underwriters' investigation deficient. Although the court acknowledged that the Underwriters had taken a number of steps to confirm the strength of the market during the quarter, the court believed that there were sufficient red flags such that a jury could find that the Underwriters "should have known" of the need to investigate further. (A15-A16).

With respect to plaintiffs' Section 10(b) claim, the court concluded that a genuine dispute existed. The Ninth Circuit acknowledged that under this Court's decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), liability under Section 10(b) requires "a mental state embracing intent to deceive, manipulate, or defraud." (A17) (quoting *Hochfelder*, 425 U.S. at 193 n.12). The court noted, however, that under *Hollinger*, 914 F.2d at 1568-69, the intent requirement may be satisfied by a showing of "recklessness." The court held that the existence of a factual dispute regarding the Underwriters' negligence also established a factual dispute on the question of recklessness. Contrary to the district court's determination that " 'should have' . . . is not the standard," the Ninth Circuit expressly held that the question whether the Underwriters "should have" known of the fraud was sufficient to support liability under Section 10(b). (A16).

Similarly, because the Underwriters "had access" to financial information that would have shown the SEC letter to be false, the Ninth Circuit concluded that a jury could find the Underwriters to have been reckless. The court did not explain how those facts could support an inference that the Underwriters knew, or even suspected, that the information needed additional investigation. Indeed, the Underwriters' actual mental state was irrelevant to the court's analysis.

The Ninth Circuit made clear that the issue was not the Underwriters' honesty, but their possible carelessness. (A16 (the Underwriters could not simply rely upon management's assurances because an underwriter "must play devil's advocate")) (citation omitted).

REASONS FOR GRANTING THE WRIT

The most basic question that can arise under Section 10(b), and the central issue in hundreds of Section 10(b) cases, is what mental state is necessary to support liability under the statute. Despite the importance of the question, and the guidance provided by the Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1975), it is a question as to which the lower courts are in complete disarray. Some courts, such as the Sixth and Ninth Circuits, have applied an "objective" standard, in which the defendant's state of mind is irrelevant. Under such a standard, liability turns on whether the defendant acted with sufficient care. Other courts, such as the Third and Seventh Circuits, have required the plaintiff to show at least "subjective" recklessness. Under a subjective standard, the defendant's actual state of mind is determinative; the inquiry is whether the defendant acted in good faith.[6]

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[6]The difference between an objective and a subjective standard has been recognized by the Court as critical in a number of different contexts. For example, it is central to this Court's analysis of the mental state necessary to show "actual malice" in public figure defamation cases. *See, e.g., Harte-Hanks Communications, Inc. v. Connaughton*, 491 U.S. 657, 689 (1989). This distinction likewise provides the basis for the Court's analysis of the "deliberate indifference" requirement in civil actions under 42 U.S.C. § 1983. *See, e.g., Farmer v. Brennan*, 114 S. Ct. 1970, 1979-80 (1994).

In the criminal law, the distinction between an objective test (which measures whether the defendant "should have been" aware of the risk) and a subjective test (which ascertains whether the defendant actually was aware of, yet disregarded, the risk) is "one of the most critical to criminal law." Paul H. Robinson, *A Brief History of Distinctions in Criminal Culpability*, 31 Hastings L.J. 815, 819-20 (1980). The analogy to criminal law may be apt in interpreting

Unable to agree whether liability under Section 10(b) is premised upon diligence or good faith, the lower courts have failed to articulate a standard that would yield consistent or predictable results with respect to scienter. The formula most commonly recited by the lower courts is "malleable enough to support virtually any conclusion"[7] — as evidenced by the fact that it has been cited in support of both "objective" and "subjective" standards.

This case presents directly the question whether an "objective" standard, in which liability may be imposed without regard to defendants' good faith, is sufficient to sustain a claim of securities fraud under Section 10(b). It also squarely presents the question whether even subjective recklessness, rather than specific intent, is sufficient under Section 10(b)'s statutory language. As the twenty years of confusion since *Hochfelder* graphically attest, the scienter question is one that urgently warrants the Court's review.

This case also poses the question whether the omission of a material fact, by itself, creates a duty of disclosure under Section 11 and Section 12(2). In reversing summary judgment on these claims, the Ninth Circuit did not find that the omitted information about the June quarter rendered misleading any specific statement in the registration statement or prospectus. Instead, the Ninth Circuit reasoned that because the information was important, it was required to be disclosed. The Ninth Circuit has thereby disregarded the language and legislative history of Sections 11 and 12(2), and has brought itself into conflict with courts in other

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the proper scope of Section 10(b), inasmuch as the statute "operates essentially as a private penal statute." *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 287 (3d Cir.) (Adams, J., concurring and dissenting), *cert. denied*, 409 U.S. 874 (1972), *cited with approval in Hochfelder*, 425 U.S. at 197.

[7] Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. Cin. L. Rev. 667, 688 (1991).

Circuits. The Ninth Circuit has adopted a rule with potentially far-reaching, and adverse, consequences for the capital markets in the United States. The Ninth Circuit's unwarranted expansion of the scope of Sections 11 and 12(2) is another question that is appropriate for review.

I. This Court Should Decide What Constitutes "Scienter" Sufficient to Support Liability Under Section 10(b) of the Securities Exchange Act of 1934

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that "scienter" — defined as an "intent to deceive, manipulate, or defraud" — is required for civil liability under Section 10(b). *Id.* at 192 n.7, 193. In rejecting negligence as a basis for Section 10(b) liability, the *Hochfelder* Court concluded that the language of the statute proscribed only "knowing or intentional misconduct." *Id.* at 197-99. Since *Hochfelder*, the Court has repeatedly reaffirmed that knowing or intentional misconduct is necessary for an action to lie under Section 10(b).[8]

In *Hochfelder*, the Court reserved the question whether "in some circumstances" recklessness might be sufficient to show "an intent to deceive, manipulate or defraud." *Id.* at 194 n.12. As discussed below, there are substantial grounds for concluding that recklessness should *not* suffice under the statutory analysis set out in *Hochfelder*. Even if the Court

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[8] *See, e.g., Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (reaffirming *Hochfelder* and emphasizing that the "language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception"); *Aaron v. SEC*, 446 U.S. 680, 690, 694-95 (1980) (*Hochfelder* scienter requirement of "knowing or intentional misconduct" applies to SEC civil enforcement actions under § 10(b)); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983) (plaintiff in § 10(b) action "must prove that the defendant acted with scienter, i.e., with intent to deceive, manipulate, or defraud"). *See also Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1447 (1994) (discussing *Hochfelder* and following its "[a]dherence to the text in defining the conduct covered by § 10(b)").

were to decide otherwise, however, such liability should be limited to "subjective" recklessness, which the common law of deceit recognized as "a form of intentional conduct." *Id.*

Neither Section 10(b) itself, nor the Court's reasoning and holding in *Hochfelder*, can be squared with the lower "objective" standard applied by the Ninth Circuit and other lower courts. As this Court found in *Hochfelder*, the language and legislative history of Section 10(b) make clear that Congress intended to limit liability to those instances "where the defendant has not acted in good faith." *Id.* at 206. Under the objective standard, however, the defendants' good or bad faith is irrelevant. The reason is that an objective standard is premised upon principles of the law of negligence, not of the law of deceit: the objective standard is concerned with the reasonableness of defendants' conduct, not with their dishonesty. In this context, it is not surprising that the objective analysis applied by the Ninth Circuit in this case is substantially indistinguishable from the negligence analysis expressly overruled in *Hochfelder* itself.

A. *The Language of the Statute is Not Consistent with the Imposition of Liability Under Section 10(b) for Mere Recklessness.*

Prior to *Hochfelder*, several lower courts, including the Ninth Circuit in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), had held that negligence was a sufficient basis for Section 10(b) liability. 425 U.S. at 193-94 n.12. Other decisions had rejected such an expansive interpretation of Section 10(b), and the Court in *Hochfelder* agreed with them. *Id.* at 12.

Noting that "the 1934 Act was intended principally to protect investors against manipulation of stock prices" *id.* at 195, the *Hochfelder* Court began its analysis by examining the language of Section 10(b). The Court found that the use "of the words 'manipulative,' 'device,' and 'contrivance' . . .

make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." *Id.* at 199. Such language, in the Court's view, plainly "connote[d] intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* The Court believed that the language of Section 10(b) "so clearly connotes intentional misconduct" that "further inquiry may be unnecessary." *Id.* at 201.

The Court nevertheless determined that examination of the legislative history would lead to the same conclusion. The Court noted that the "most relevant exposition of the provision" in the legislative history was that of a spokesman for the drafters that Section 10(b), who described Section 10(b) as "say[ing], 'Thou shalt not devise any other cunning devices.'" Other passages similarly stated that the provision was "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function," and as providing relief for investors who have "suffered loss by reason of illicit practices." *Id.* at 202, 204-05. The use of terms such as "cunning," "manipulative," and "illicit," plainly gave "no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith." *Id.* at 206.

Based on Section 10(b)'s language and legislative history, therefore, the Court concluded that liability under Section 10(b) requires "a mental state embracing intent to deceive, manipulate, or defraud." In a footnote, *Hochfelder* reserved the question whether "under some circumstances" recklessness might satisfy this intent standard. In doing so, the Court noted that under the common law, recklessness may sometimes be "considered to be a form of intentional conduct." *Id.* at 194 n.12. The Court concluded that it did not need to address whether such reckless behavior could satisfy the potentially higher standard set by the statutory language of Section 10(b).

Although lower courts have held that recklessness is sufficient basis for liability under Section 10(b), that conclusion cannot be squared with the statutory language that the Court found compelling. The use of the word "manipulative" in the statute, which the Court found to be "especially significant," was "virtually a term of art when used in connection with securities markets." *Id.* at 199. The Court explained its meaning in the securities context as "to force (prices) up or down, as by matched orders, wash sales, fictitious reports; to rig." *Id.* at 199 n.21. Such an interpretation, with its emphasis on a deliberate scheme, is inconsistent with merely reckless conduct — as is the statute's use of the qualifying terms "device" and "contrivance." To the same effect is "the most relevant exposition" of the statute in the legislative history, which, as noted above, summarized Section 10(b) as "thou shalt not devise any other cunning devices." *Id.* at 202. One cannot "devise cunning devices" simply by acting recklessly — such conduct is only the product of deliberate design.

In holding that recklessness suffices as a basis for Section 10(b) liability, the courts of appeals have not attempted to square the concept of recklessness with this statutory language. Instead, they rely upon the analogy between Section 10(b) and common law tort claims, and the broad remedial purposes of the statute.[9] As this Court emphasized in

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[9] *See, e.g., Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 45 (2d Cir.) ("[i]t is unquestionable that the common law has served as an interpretive source of securities law concepts," and there is "no hint in *Hochfelder* that the Court intended a radical departure from [the] common law analogue of fraud") (citations and quotations omitted), *cert. denied*, 439 U.S. 1039 (1978); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979) (it "is very useful to analogize" between § 10(b) and common law fraud, inasmuch as § 10(b) "is to be liberally construed in order to effectuate the policies underlying the federal securities laws"); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir.) ("it would be highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs"), *cert. denied*, 434 U.S. 875 (1977); *Hackbart v. Holmes*, 675 F.2d

Central Bank, however, "the statutory text controls the definition of conduct covered" by Section 10(b), not analogies to the common law which find no support in the language of the statute. 114 S. Ct. at 1447. Nor do "generalized references to the 'remedial purposes' of the 1934 Act ... justify reading a provision more broadly than its language and the statutory scheme reasonably permit." *Touche Ross & Co. v. Redington,* 442 U.S. 560, 578 (1979) (quotations and citations omitted). Recklessness, even conscious recklessness, does not satisfy the plain language of Section 10(b), and is not consistent with the statute's legislative history. The question reserved in *Hochfelder,* therefore, properly should be answered "no" — recklessness is not sufficient to provide a basis for securities fraud liability under Section 10(b).

B. *Even if Recklessness Were Sufficient Under Section 10(b), Such Recklessness Should be Limited to "Subjective" Recklessness.*

Even if recklessness might "under some circumstances" provide a basis for Section 10(b) liability, *Hochfelder* plainly did not intend to create an exception to its holding requiring "a mental state embracing intent." 425 U.S. at 194 n.12. Rather, the Court recognized that the common law under certain circumstances had found that recklessness could be "a *form* of intentional conduct." *Id.* (emphasis added). The leading case in deceit law,[10] *Derry v. Peek,* 14

1114, 1117-18 (10th Cir. 1982) (adopting recklessness "for the same reasons given by the other circuits," i.e., "because the Securities Acts are to be broadly construed to achieve their remedial goals," "because requiring the plaintiff to show intent would be unduly burdensome," and "because the Securities Acts were intended to proscribe actions akin to common law fraud").

[10] It was well-established at the time Section 10(b) was enacted that common law liability for misrepresentations fell within three different "fields of tort law — liability for intended wrongs, negligent wrongs, and a species of liability without fault." Fowler V. Harper & Fleming James, Jr., *The Law of Torts* § 7.3, at 537 (1956). *See, e.g.,* Francis H. Bohlen, *Misrepresentations as Deceit,*

App. Cas. 337 (U.K. 1889), established that "the necessary fraud required to sustain the action for deceit was actual fraud, i.e., a conscious misrepresentation." Harper & James, *supra*, § 7.3, at 533. At the same time, *Peek* and its progeny recognized that a person may make a conscious misrepresentation by asserting a fact to be true, for the purpose of inducing reliance, where "he knows that he does not know whether [the fact] is true or false — in other words, *with subjective recklessness.*" *Id.* at 534 (emphasis added). As one treatise summarized the boundaries of liability for intentional misrepresentations under the common law:

> Deceit, as an intended wrong, should be confined to situations in which the defendant (a) knew that his statements were untrue, or (b) knew that he did not know whether they were true or false, and thus made the statements in reckless disregard of their truth or falsity. In each situation, there is no "honest" belief in the truth.

Id. at 537.

Common law deceit, "in short, makes honest belief in the truth a complete defense, under all circumstances." *Id.* at 534. Nothing in *Hochfelder* provides the least support for going beyond such subjective recklessness in imposing liability under Section 10(b). As discussed below, however, and as this case vividly demonstrates, liability under Section 10(b) is now being imposed without any regard to the defendant's actual mental state. Indeed, the principles and analysis applied by the Ninth Circuit below were recognized in the common law as drawn not from the law of deceit but from the law of negligence — precisely the theory of liability that this Court unequivocally rejected in *Hochfelder.*

Negligence or Warranty, 42 Harv. L. Rev. 733 (1929). Liability for intentional misstatements was governed by the law of deceit; negligent misstatements by negligence law; and non-negligent statements by principles of warranty. Harper & James, *supra*, § 7.3, at 536.

1. *The lower courts are in complete disarray as to whether to apply a subjective or objective recklessness standard.*

In this Court's decision last Term in *Central Bank,* the Court emphasized the importance of clear and predictable rules regarding what conduct may be subject to liability under Section 10(b). Noting that Section 10(b) litigation "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general," the Court observed with respect to the question of aiding and abetting liability under Section 10(b):

> [T]he rules for determining . . . liability are unclear, in an area that demands certainty and predictability. That leads to the undesirable result of decisions made on an ad hoc basis, offering little predictive value to those who provide services to participants in the securities business. Such a shifting and highly fact-oriented disposition . . . is not a satisfactory basis for a rule of liability imposed on the conduct of business transactions.

Central Bank, 114 S. Ct. at 1454 (citations and quotations omitted).

Notwithstanding its undesirable consequences, "ad hoc" and "unpredictable" are the principal hallmarks of lower court decisions regarding the mental state required for Section 10(b) liability. Commentators since *Hochfelder* have been uniform in their criticism of the chaos among the lower courts on this issue. *See, e.g.,* Johnson, *supra,* at 674-75, 686 (caselaw is "ad hoc," if "not largely incoherent," and litigation since *Hochfelder* "has done precious little to clarify the ambiguities"; the result is "that actual and potential parties to Section 10(b) and Rule 10b-5 actions cannot predict with any degree of certainty how a trier of fact will characterize challenged conduct and thus

whether it may serve as the basis for liability").[11] Lower courts likewise have bemoaned the lack of any uniformity even among courts within the same Circuit.[12]

Central to this inconsistency is the lack of agreement as to whether Section 10(b) liability turns on what the defendant's mental attitude actually was, or on what it should have been. Some lower court decisions have held that *Hochfelder* cannot be extended beyond the subjective recklessness found actionable in common law deceit. For exam-

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[11] *Accord* Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense,* 11 J. Corp. L. 179, 180 (1986) (there is "little uniformity ... among the circuits or even among different panels of the same circuit, on how proof of recklessness should be used to satisfy scienter"; quoting one district court judge's observation that the issue "has served as a veritable quagmire for the courts"); Marc I. Steinberg & Samuel H. Gruenbaum, *Variations of "Recklessness" After Hochfelder and Aaron,* 8 Sec. Reg. L. J. 179, 181, 183 (1980) (Courts of Appeals "have split deeply" on the meaning of recklessness, with a resulting "deep substantive impact" on the outcome of cases). *See also* Thomas Lee Hazen, *The Law of Securities Regulation* 460 (1985) (recklessness standard sufficient to meet *Hochfelder* "seems to defy a more specific definition," and "[r]esolution of the availability of a recklessness standard, as well as a more explicit definition, must await Supreme Court determination").

The confusion among the district courts in the Second Circuit, where a significant number of Section 10(b) claims arise, is illustrative of the chaos that reigns on the scienter issue. *Compare, e.g., In re Leslie Fay Co., Sec. Litig.,* 835 F. Supp. 167, 172 (S.D.N.Y. 1993) (recklessness sufficient to satisfy Section 10(b) only "where the defendant *deliberately* failed to acquire the information that would have indicated that his statements were false and misleading") (emphasis in original) *and In re Fischbach Corp. Sec. Litig.,* [Current Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,665, at 92,092 (S.D.N.Y. Jan. 15, 1992) (same) *with CMNY Capital, L.P. v. Deloitte & Touche,* 821 F. Supp. 152, 165 (S.D.N.Y. 1993) (scienter standard satisfied at point where "negligence shades into recklessness"; liability appropriate where conduct is "highly unreasonable" and represents "an extreme departure from the standards of ordinary care").

[12] *See, e.g., In re Leslie Fay,* 835 F. Supp. at 172 & n.1 (the appropriate scienter standard "is indeed a murky area of law in this circuit," and "the confusion over what must be pled and what must be proven to show scienter in a 10b-5 case is so severe that it has resulted in conflicting opinions in the same case").

ple, in *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979), the Third Circuit held that under *Hochfelder*, the "issue is whether the defendants had an honest belief that the statements made by them were true." If the defendants "did have that honest belief, whether reasonably or unreasonably, they are not liable." *Id.* at 1198 (quotations and citations omitted). The central inquiry, as in deceit law, is the defendant's state of mind: a defendant can be held liable only if the plaintiff can "establish that the defendant lacked a genuine belief that the information disclosed was accurate and complete in all material respects." *Id.*

Similarly, in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977), the Seventh Circuit held that subjective recklessness is necessary for Section 10(b) liability. Ironically, *Sundstrand* did so in the course of utilizing a definition of recklessness that does not have a subjective component. This definition, which has become the one most frequently quoted by lower courts, states that:

> [R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

553 F.2d at 1045.

The *Sundstrand* court recognized that the "knew or must have known" language in this definition was an objective test. *Id.* at 1045 n.19. The Seventh Circuit nevertheless found implicit in its definition an additional, subjective test that requires "something more egregious than even 'white heart/empty head' good faith." *Id.* at 1045. Under this separate, subjective requirement, *Sundstrand* concluded

that if "a defendant genuinely forgot to disclose information or . . . it never came to his mind," it would defeat a finding of recklessness "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20.

Unlike the Third and Seventh Circuits in *McLean* and *Sundstrand*, other courts of appeals have explicitly adopted an objective standard. For example, in *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979), the Sixth Circuit concluded that "*Hochfelder* should be read to go no further than its specific holding that *mere* negligence is not enough for liability" (emphasis added). In support of its use of an objective test, the *Mansbach* court purported to find support in this Court's "actual malice" defamation cases, *id.* at 1025 — an analogy which, as discussed *infra*, undermines rather than bolsters the use of an objective test. Finding that there was "little analytical value" in defining where recklessness falls along the spectrum from intent to negligence, *id.* at 1025 n.36, the court concluded that it was enough to say that recklessness is:

> highly unreasonable conduct which is an extreme departure from the standards of ordinary care. While the danger need not be known, it must at least be so obvious that any reasonable man would have known of it.

Id. at 1025.

In *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991), the Ninth Circuit sided with those courts applying an objective standard that measures the defendants' reasonableness rather than their good faith.[13] Although

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[13] Prior to *Hollinger*, the Ninth Circuit had been particularly schizophrenic on the issue, with different panels adopting flatly inconsistent approaches to the question. *Compare, e.g., Keirnan v. Homeland*, 611

Hollinger noted *Sundstrand's* observation that something more egregious than "white heart/empty head" good faith should be required, 914 F.2d at 1570, the Ninth Circuit did not adopt this subjective requirement. Rather, the Ninth Circuit expressly *rejected* the SEC's proposal that it adopt a standard that turned on a defendant's subjective awareness.[14] Instead, like the Sixth Circuit in *Mansbach*, the Ninth Circuit framed the inquiry in terms that provide no room for asking what the defendant's mental state actually was. The only question is what it should have been:

> In applying the *Sundstrand* test to the facts of this case, the essential inquiry becomes: Was Titan's failure to disclose Wilkowski's eleven-year old forgery conviction highly unreasonable and did it constitute an extreme departure from standards of ordinary care?

914 F.2d at 1570.

2. *The inconsistent standards applied by the lower courts lead to conflicting outcomes even in cases presenting virtually identical facts.*

Given the fundamental disagreement among the courts as to whether Section 10(b) liability turns on the defendants' good faith or on their level of care, it is not surprising that cases involving virtually identical facts have resulted in

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F.2d 785, 788 (9th Cir. 1980) (finding recklessness where defendant had "reasonable grounds" for investigating but failed to do so) *with Pegasus Fund, Inc. v. Laraneta*, 617 F.2d 1335, 1340 (9th Cir. 1980) (no finding of recklessness could be supported unless the defendant "acted other than in good faith").

[14] *See Hollinger*, 914 F.2d at 1569 n.7 (rejecting SEC's proposed standard of "conscious" indifference). *Compare Farmer*, 114 S. Ct. at 1980 (standard requiring "conscious" disregard focuses "on what a defendant's mental attitude actually was (or is), rather than what it should have been (or should be)").

contradictory outcomes.[15] This case provides a clear example. The Ninth Circuit here found it sufficient to support Section 10(b) liability that the Underwriters were aware of facts suggesting that June would be a slow quarter. The Court concluded that such facts arguably should have caused the Underwriters not to rely on assurances from the company and its counsel, even though none of the facts identified by the Ninth Circuit called into question the company's or its counsel's integrity at the time. (A14-A19).

By comparison, in *In re Crazy Eddie Securities Litigation*, 817 F. Supp. 306 (E.D.N.Y. 1993), plaintiffs pointed to the underwriters' knowledge of facts raising credibility issues regarding certain officers, and contended that such facts would support an inference that the underwriters "placed too much reliance on comfort letters and failed to conduct their own inquiries." *Id.* at 316. The district court rejected plaintiffs' argument. The court held that the most that could be inferred from those facts was that the underwriters were negligent; the facts provided no basis for raising a genuine issue as to whether the underwriters "deliberately shut their eyes to the fraud." *Id.*[16]

Equally at odds with the Ninth Circuit's decision is the Third Circuit's holding in *McLean*. In that case, as here, the plaintiffs alleged that the defendant auditor failed to uncover the company's consignment sales. The district court held that the defendant "must have been" aware of discrepancies

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[15] As one commentator has observed, because of the imprecision of the law in this area, it is common to find instances where "[o]ne judge may deem an accused party to have acted recklessly, while a different judge in another case may exonerate a defendant charged with nearly identical conduct." Johnson, *supra*, at 674 & n.24.

[16] *See also O'Brien v. National Property Analysts Partners*, 719 F. Supp. 222, 228 (S.D.N.Y. 1989) ("a purported failure to investigate does not rise above the level of negligence, which is legally insufficient" to show scienter) (citations and quotations omitted).

in purchase orders and sales invoices and thus aware of the fraud. 599 F.2d at 1199-1202. The Third Circuit reversed, holding that such an inference was not permissible. The court observed, in language equally applicable to this case:

> [W]e cannot hold that these factors, standing alone, were evidence that [the auditor] was aware that it was without sufficient knowledge to form that opinion. Such a holding would obliterate the distinction between tortious conduct requiring scienter, which the *Hochfelder* construction of § 10(b) demands, and negligence, which *Hochfelder* found insufficient.

Id. at 1200. *See also Sanders v. John Nuveen & Co.*, 554 F.2d 790, 792-93 (7th Cir. 1977) (allegation that a diligent investigation would have uncovered the fraud insufficient to sustain inference of intent required under *Hochfelder*).

C. *The Objective Rule Applied by the Ninth Circuit and Other Courts Amounts to the Imposition of Section 10(b) Liability Under a Negligence Standard.*

The effort to hold securities professionals liable under Section 10(b) on the theory that they "failed to investigate" has been a frequently recurring one. Indeed, that was the theory underlying plaintiffs' claim in *Hochfelder*, with plaintiffs contending (and the court of appeals agreeing) that there was a genuine issue whether the auditor had breached its duty of inquiry, and "whether inquiry and disclosure would have led to the discovery or prevention of [the] fraud." 425 U.S. at 193. As this Court recognized in *Hochfelder*, the plaintiffs' theory of liability in that case was bottomed on principles of negligence. It is precisely that theory which underlies the Ninth Circuit's analysis here.

The extent to which the Ninth Circuit has come full circle may be gauged in part by reference to its decision in *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974), which

Hochfelder overruled. *See* 425 U.S. at 193 n.12. In *White*, the Ninth Circuit held that liability is permitted for "mere negligence" under a standard that determines whether the defendant "failed or refused to ascertain such facts when they were available to him *or could have been discovered by him with reasonable effort.*" *White*, 495 F.2d at 732. That is precisely the basis, however, on which the Ninth Circuit would permit liability in the case at bar. Although conceding that there is no evidence that the Underwriters actually knew of the June results, the Ninth Circuit found it sufficient that the Underwriters "*had access* to all information that was available" regarding the June numbers. (A18) (emphasis added). As the Ninth Circuit itself recognized in *White*, such a theory is not one that "requir[es] some degree of scienter or culpability" — it is, instead, a theory of "mere negligence." *White*, 495 at 732.

This Court's "actual malice" cases, which, as the Sixth Circuit observed in *Mansbach*, provide a useful analogy applying common law scienter principles, *see* 598 F.2d at 1025, reflect just how far the Ninth Circuit has strayed from requiring "knowing or intentional misconduct." In defamation decisions, the Court has held that liability may be imposed for a statement made "with knowledge that it was false or with reckless disregard of whether it was false or not." *New York Times Co. v. Sullivan*, 376 U.S. 254, 280 (1964). As the Court has emphasized in that context, the "reckless disregard" that may be considered equal to a knowledge of falsity is *subjective* recklessness. It is measured by the defendant's actual state of mind, not by the reasonableness of the defendant's conduct. Thus, the Court observed in *Harte-Hanks Communications, Inc. v. Connaughton*, 491 U.S. 657 (1989):

> A reckless disregard for the truth, however, requires more than a departure from reasonably prudent conduct. There must be sufficient evidence to permit the

> conclusion that the defendant in fact entertained serious doubts as to the truth of his publication. The standard is a subjective one — there must be sufficient evidence to permit the conclusion that the defendant actually had a high degree of awareness of . . . probable falsity.

491 U.S. at 688 (citations and quotations omitted).

Such subjective consciousness cannot be shown using the kind of objective test adopted by the Ninth Circuit in *Hollinger*. Indeed, in *Harte-Hanks*, the Court expressly rejected a standard indistinguishable from that employed by the Ninth Circuit in Section 10(b) cases. *Compare Harte-Hanks*, 491 U.S. at 664 (rejecting standard that "merely required a showing of 'highly unreasonable conduct constituting an extreme departure from the standards . . . ordinarily adhered to by responsible publishers' ") *with Hollinger*, 914 F.2d at 1570 (the "essential inquiry" is whether the defendant's "failure to disclose [a particular fact was] highly unreasonable and did it constitute an extreme departure from standards of ordinary care"). Similarly, *Harte-Hanks* held that the failure to conduct an investigation, without more, does not suffice to raise an inference of subjective recklessness. *See* 491 U.S. at 688 (a "failure to investigate before publishing, even when a reasonably prudent person would have done so, is not sufficient to establish reckless disregard").

Mansbach correctly observed, the Court's defamation cases are indicative of the extent of the "equation of recklessness with subjective intent (scienter) in tort law." 598 F.2d at 1025. As the analogy provided by these defamation cases illustrates, however, the standard applied by the Ninth Circuit in permitting Section 10(b) liability here is far lower than that required under the common law to show the equivalent of knowledge or intent. The Court in *Hochfelder* held that "knowing or intentional misconduct," 425 U.S. at

197, was necessary under Section 10(b), and reserved only the question whether "recklessness [that] is considered to be a form of intentional conduct" might also be enough. *Id.* at 194 n.12. In this and other Section 10(b) cases, however, liability is being imposed on a quite different, and lower, basis. As the Ninth Circuit recognized long ago in *White v. Abrams*, that basis is one that cannot meaningfully be distinguished from negligence.

II. This Case also Presents the Question Whether the Materiality of an Omitted Fact Creates a Duty of Disclosure Under Section 11 and Section 12(2).

In mid-August 1990, one month after the prospectus and registration statement went effective, Toolworks issued a press release announcing its results for the June quarter.[17] This report, with which the Underwriters were not involved, contained allegedly false June quarter financial results. Ordinarily, a claim that an earnings release or Form 10-Q contains false or misleading information would give rise to a claim against the company under Section 10(b) or Section 18 of the 1934 Act. Here, however, plaintiffs have sought to invoke the 1933 Act's less rigorous requirements, in order to reach the Underwriters' and auditor's deep pockets. In sanctioning that effort, the Ninth Circuit concluded that the simple nondisclosure of a material fact can support liability under Section 11 and Section 12(2). The Ninth Circuit's rule constitutes an unprecedented expansion of liability and

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[17]The fact that Toolworks took several weeks to announce its quarterly results is not unusual: as a review of any newspaper's financial pages would attest, public companies typically require anywhere from two to six weeks to compile quarterly results from the information in their various accounting records. The SEC's regulations tacitly recognize the amount of time that can be involved in the preparation of such records by allowing companies 45 days after the close of a quarter in which to file their reports on Form 10-Q. General Instruction A.1 to SEC Form 10-Q.

cannot be reconciled with the language, legislative history, or purpose of the 1933 Act.[18]

The Ninth Circuit's approach is inconsistent with the statutory language and legislative history of the 1933 Act. To begin with, Section 11 and Section 12(2) by their terms require the identification of a specific statement that is either untrue, or that is rendered misleading by an omitted fact. Section 11 provides that the plaintiff must prove that the registration statement "contain[s] an untrue statement of a material fact or omit[s] to state a material fact . . . necessary to make *the statements therein* not misleading" (emphasis added). The section does not provide that it is sufficient for an omission to make "the registration statement" misleading. Rather, it expressly distinguishes between the registration statement and "the statements therein;" it is the latter — not the former — that must be proven to be rendered misleading by an omission. In similar fashion, Section 12(2) limits liability to circumstances where the prospectus "includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statement, in light of the circumstances under which they were made, not misleading." Again, the statute provides that it is the "statement" that is "included" in the prospectus, not the prospectus as a whole, that must be rendered misleading by an omission.[19]

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[18] Insofar as the Ninth Circuit predicated Section 12(2) liability on the SEC letter itself, which it appeared to do in part, *see* A14-A15, it plainly is reversible error, because the letter was never part of the prospectus. *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995). The letter similarly was never part of the registration statement, and therefore cannot afford a basis for liability under Section 11. *See, e.g., Mayer v. Oil Field Sys. Corp.*, 803 F.2d 749, 755 (2d Cir. 1986).

[19] Unlike Section 12(2), Section 11 also provides that liability may be based upon the failure "to state a material fact required to be stated" in the registration statement. The Ninth Circuit did not reach plaintiffs' argument that the failure to include the June quarterly financial results

The clear import of the statutory language is borne out by the Act's legislative history. Although the legislative history on certain aspects of the 1933 Act is "sparse,"[20] on this question the legislative history unequivocally bears out the natural import of the statutory language. After the conference between the House and Senate on their respective versions of the bill, the House managers attached a commentary to the final version of the 1933 Act. That report addressed the distinctions between the House and Senate versions and how those differences were resolved. With respect to Section 11, the House conference report stated as follows:

> The Senate amendment imposed liability upon persons making false and deceptive statements in connection with the distribution or sale of a security. The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. *This phrase has been clarified in the substitute to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making a mere omission — unless the act expressly requires such a fact to be stated — a ground for liability where no circumstances exist to make the omission itself misleading.*

H.R. Rep. 152, 73rd Cong., 1st Sess. at 26 (1933) (Conference Report submitted in House and agreed to, May 22,

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fell within the scope of this provision because the results constituted a "known trend" under Item 303 of the SEC's Regulation S-K, 17 C.F.R. § 229.303(a)(3)(ii). This argument has been rejected by numerous courts. *See, e.g., Anderson v. Clow*, [1993 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807, at 97,989 (S.D. Cal. Sept. 17, 1993) (Item 303(a) applies only to reports filed on Form 10-K, and "omitting Item 303(a) information from a Prospectus does not violate § 11").

[20] *See, e.g., Randall v. Loftsgaarden*, 478 U.S. 647, 657 (1986) (characterizing legislative history of § 12(2)).

1933), 77 Cong. Rec. 3891, 3902 (1933) (emphasis added).[21]

Notwithstanding this unequivocal statutory and legislative language, the Ninth Circuit has adopted a rule directly to the contrary: a "mere omission" is actionable regardless of whether it "relate[s] to the statements made" in the prospectus. Thus, in holding that a jury could decide that the omission of the June information could render the prospectus misleading, the Ninth Circuit did not identify a single statement or statements in the prospectus that related to or hinted at Toolworks' results or performance for the June quarter. Indeed, it did not determine that any statement or statements in the prospectus could be viewed as "forward-looking" in any way. Rather, it was enough simply to conclude that the "prospectus" was rendered misleading by the omission. In other words, as the Ninth Circuit's own analysis (set out here in its entirety) makes clear, the potential materiality of the information generated the duty to disclose, regardless of whether it related to any specific statement previously made by the defendants:

> The Underwriters' contention that the events of this [June] period are inapplicable to sections 11 and 12(2) liability is clearly incorrect. Both statutory provisions require disclosure of information needed in order to make a prospectus truthful and not misleading. As the Underwriters' own experts [sic] testified, poor first quarter earnings prior to the effective date of the offering would definitely constitute material information and would have to be disclosed.

(A13 n.2).

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[21] The Senate passed the final version of the 1933 Act without any commentary by the Senate managers. May 22-23, 1933, 77 Cong. Rec. 3879-3888, 4009 (1933).

In holding that a pure omission can provide the basis for an actionable claim under Section 11 and Section 12(2), the Ninth Circuit has brought itself squarely into conflict with courts in other Circuits. As one commentator summarized, the law previously has been that "a Section 11 [or 12(2)] plaintiff must identify specific representations of fact in the registration statement or specific statements that were made misleading by reason of any of the alleged omissions." J. William Hicks, *Civil Liabilities: Enforcement & Litigation Under the 1933 Act* § 4.05[1][a], at 4-63-64 (1994). Indeed, courts in other Circuits specifically have rejected attempts simply to point to the prospectus or registration statement as a whole and claim that the "general picture" is altered by the omitted information. Rather, a threshold requirement for Section 11 and 12(2) liability has been the identification of a particular statement rendered misleading by the alleged omission.[22]

The Ninth Circuit's decision potentially will affect not only 1933 Act cases, but also cases arising under the 1934 Act, where both Rule 10b-5 and Rule 14a-9 (relating to proxy statements) include language virtually identical to

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[22] *See, e.g., In re Bank of Boston Corp. Sec. Litig.*, 762 F. Supp. 1525, 1538 (D. Mass. 1991) (rejecting Section 11 and 12(2) claims based on theory that omitted fact would have materially altered the "general picture" created by prospectus and registration statement; claim not sustainable where plaintiffs "cannot identify a single statement in either the Registration Statement or the Prospectus that became misleading as a result of the Bank's failure to disclose certain financial information"); *In re Union Carbide Class Action Sec. Litig.*, 648 F. Supp. 1322, 1326 (S.D.N.Y. 1986) (no liability under § 11 or § 12(2) where plaintiffs only "assert vaguely that a false and misleading impression was created" by prospectus and registration statement; a "threshold requirement" under both statutory provisions "is the presence of an affirmative statement that is made misleading by the material omission").

that at issue in this case.[23] Plaintiffs' counsel in private securities class actions also are likely to resort to this "pure omission" theory as a means of significantly expanding the number and scope of 1933 Act claims in the future.[24]

Finally, the Ninth Circuit's rule potentially will have a chilling effect on the capital markets in the United States that is directly contrary to the statutory purposes sought to be forwarded by the 1933 Act. In enacting that legislation, Congress' underlying goal was to stimulate private investment and encourage capital formation by American corporations. The disclosure and liability provisions of the Act were intended to restore public confidence in the system for

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[23] Courts interpreting these provisions regularly have rejected claims that an omission can be actionable unless the plaintiff identifies a particular statement or statements that are rendered misleading. *See, e.g., In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) ("an omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts."), *cert. denied*, 114 S. Ct. 1397 (1994); *Backman v. Polaroid Corp.*, 910 F.2d 10, 13 (1st Cir. 1990) (en banc) (rejecting claim that § 10(b) imposes liability for the nondisclosure of material information absent the identification of specific "inaccurate, incomplete, or misleading prior disclosures"); *Staffin v. Greenberg*, 672 F.2d 1196, 1204 (3d Cir. 1982) (no duty to disclose material omitted information under §§ 10(b) and 14(e) absent a statement made misleading); *Ash v. Brunswick Corp.*, 405 F. Supp. 234, 245 (D. Del. 1975) (in interpreting nearly identical language in Rule 14a-9 regarding proxy statements, court held that although omitted information was material, "[o]missions constitute violations of the Act only if they are both material and make other statements false or misleading").

[24] Indeed, after the Ninth Circuit's ruling in *Toolworks*, plaintiffs successfully avoided a motion to dismiss in *Slate v. Mitzner*, [Current Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,707 (N.D. Ga. Mar. 29, 1995), on the ground that a prospectus that went effective on January 25, 1994 had to include results for the December quarter.

the purpose of leading to a resumption of investment activity. One commentator has noted:

> In order to stimulate private investment, the civil liability provisions in the Act had to strike a delicate balance. On the one hand, the threat of liability had to appear sufficiently real to deter the kind of irresponsible conduct which had contributed to the public's loss of faith. On the other hand, liabilities so severe as to discourage new offerings *would defeat the ultimate purpose of the Act which was, after all, to encourage new financing for private industry.*

Michael P. Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market,* 58 Va. L. Rev. 776, 798 (1972) (emphasis added).[25]

The Ninth Circuit's holding, however, is likely to have precisely the opposite effect. The Ninth Circuit's ruling, at bottom, is that an issuer must disclose the results for the issuer's most recent quarter. Once a quarter has been completed, therefore, the issuer faces the risk of "virtually absolute" liability[26] if it does not include a preliminary financial statement for that quarter. At the same time, because it can be held liable even for innocent misstatements, the issuer is unlikely to be willing to include financial results that pose any risk of a mistake. The logical result would appear to be that a period of between three and six weeks out of every quarter — and, hence, three to six months out of every year — will become a *de facto* "quiet

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[25] *See also* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System,* 9 J. Corp. L. 1, 51 (1983) (Act was intended to "help facilitate an increased level of corporate securities sales").

[26] *Herman & MacLean v. Huddleston,* 459 U.S. 375, 382 (1983) ("[l]iability [under § 11] against the issuer of a security is virtually absolute, even for innocent misstatements").

period" during which there are no public offerings or other transactions covered by Sections 11 and 12(2).

The Ninth Circuit's creation of a "pure omission" standard of liability cannot be reconciled with the language or legislative history of the 1933 Act, it undermines the underlying purposes of the Act, and it is at odds with other cases that have previously interpreted these provisions. It also has the potential for dramatically expanding the scope of claims that may be brought under both the 1933 and 1934 Acts. The Court accordingly should grant certiorari to consider whether pure omissions may be used as the basis for imposing liability under Sections 11 and 12(2), as allowed by the Ninth Circuit below.

CONCLUSION

For all of these reasons, certiorari should be granted.

Respectfully submitted,

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June 9, 1995

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

In re SOFTWARE TOOLWORKS, INC. SECURITIES LITIGATION

RICHARD B. DANNENBERG, On Behalf of Himself and all others Similarly Situated,
Plaintiff,

and

MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, trustees of William J. Bing and Arlene S. Bing Living Trust, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, and JACK SCHNITZER,
Plaintiffs-Appellants,

v.

PAINEWEBBER INC., MONTGOMERY SECURITIES and DELOITTE & TOUCHE,
Defendants-Appellees.

No. 94-16150.
D.C. NO. CV-90-02906 FMS
ORDER AND AMENDED OPINION
Submitted Aug. 23, 1994.*
Decided Oct. 19, 1994.

Amended on Denial of Rehearing and Suggestion for Rehearing en banc March 13, 1995.

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* This panel unanimously agrees that this case is appropriate for submission without oral argument. Fed. R. App. P. 34(a); 9th Cir. R. 34-4.

BEFORE: HALL, THOMPSON, Circuit Judges, LAY, Senior Circuit Judge of the Eighth Circuit, Sitting by Designation

OPINION

HALL, Circuit Judge:

In this case, we again consider the securities-fraud claims raised by disappointed investors in Software Toolworks, Inc., who appeal the district court's summary judgment in favor of auditors Deloitte & Touche and underwriters Montgomery Securities and PaineWebber, Inc. We affirm in part, reverse in part, and remand.

I.

In July 1990, Software Toolworks, Inc., a producer of software for personal computers and Nintendo game systems, conducted a secondary public offering of common stock at $18.50 a share, raising more than $71 million. After the offering, the market price of Toolworks' shares declined steadily until, on October 11, 1990, the stock was trading at $5.40 a share. At that time, Toolworks issued a press release announcing substantial losses and the share price dropped another fifty-six percent to $2.375.

The next day, several investors ("the plaintiffs") filed a class action alleging that Toolworks, auditor Deloitte & Touche ("Deloitte"), and underwriters Montgomery Securities and PaineWebber, Inc. ("the Underwriters") had issued a false and misleading prospectus and registration statement in violation of sections 11 and 12(2) of the Securities Act of 1933 ("the 1933 Act") and had knowingly defrauded and assisted in defrauding investors in violation of section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ("the 1934 Act"). Specifically, the plaintiffs claimed that the defendants had (1) falsified audited finan-

cial statements for fiscal 1990 by reporting as revenue sales to original equipment manufacturers ("OEMs") with whom Toolworks had no binding agreements, (2) fabricated large consignment sales in order for Toolworks to meet financial projections for the first quarter of fiscal 1991 ("the June quarter"), and (3) lied to the Securities Exchange Commission ("SEC") in response to inquiries made before the registration statement became effective.

Toolworks and its officers quickly settled with the plaintiffs for $26.5 million. After the completion of discovery, the district court granted summary judgment in favor of the Underwriters on all claims and in favor of Deloitte on all claims other than one cause of action under section 11. *See In re Software Toolworks, Inc. Sec. Litig.*, 789 F. Supp. 1489 (N.D. Cal. 1992) [*Toolworks I*]. The district court held that (1) the Underwriters had established a "due diligence" defense under sections 11 and 12(2) as a matter of law, *id.* at 1494-98, (2) Deloitte had made no material misrepresentations or omissions, other than the OEM revenue statements, on which liability under sections 11 and 12(2) could attach, *id.* at 1510-11, and (3) the plaintiffs had failed to establish that any defendant acted with scienter, a necessary element of liability under section 10(b), *id.* at 1498-1510.

The plaintiffs dropped their remaining section 11 claim (regarding OEM revenue) against Deloitte and filed a timely appeal. We dismissed for lack of jurisdiction because the plaintiffs had failed to obtain Rule 54(b) certification to appeal the district court's nonfinal order. *See Dannenberg v. Software Toolworks, Inc.*, 16 F.3d 1073 (9th Cir. 1994) [*Toolworks II*]. The district court subsequently entered a Rule 54(b) order and the merits of the plaintiffs' appeal is now properly before us.

"We conduct *de novo* review of the district court's grant of summary judgment. In so doing, we are mindful that, although materiality and scienter are both fact-specific is-

sues which should ordinarily be left to the trier of fact, summary judgment may be granted in appropriate cases. Summary judgment may be defeated in a securities fraud derivative suit only by showing a genuine issue of fact with regard to a particular statement by the company [or its professionals] . . ." *Miller v. Pezzani (In re Worlds of Wonder Sec. Litig.)*, No. 93-15321 (9th Cir. Sept. __, 1994), slip op. at _____ (citations and quotations omitted) [*WOW II*].

II.

We first address the plaintiffs' claims against the Underwriters under sections 11 and 12(2) of the 1933 Act[1] Section 11 imposes liability "[i]n case any part of [a] registration statement . . . contain[s] an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(a). Similarly, section 12(2) imposes liability for using a prospectus "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading." *Id.* § 77l(2).

Liability under sections 11 and 12(2) properly may fall on the underwriters of a public offering. *See id.* §§ 77k(a)(5), 77l(2). Underwriters, however, may absolve themselves from liability by establishing a "due diligence" defense. Under section 11, underwriters must prove that they "had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements

[1]The plaintiffs do not appeal the district court's partial summary judgment in favor of Deloitte on the section 11 and 12(2) claims.

therein not misleading." *Id.* § 77k(b)(3). Similarly, under section 12(2), underwriters must show that they "did not know, and in the exercise of reasonable care, could not have known, of [the] untruth or omission." *Id.* § 77l(2).

Because section 11's "reasonable investigation" standard is similar, if not identical, to section 12(2)'s "reasonable care" standard, *see Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1228 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981), the analysis of each on summary judgment is the same, *see Weinberger v. Jackson*, [1990-91] Fed. Sec. L. Rep. (CCH) ¶ 95,693 at 98,255 (N.D. Cal. 1990). In determining whether an underwriter meets the due diligence test under either provision, "the standard of reasonableness shall be that required of a prudent man in the management of his own property." 15 U.S.C. § 77k(c); *see* 17 C.F.R. § 230.176 (factors affecting the reasonableness of an investigation under section 11). Thus, due diligence is, "[i]n effect, . . . a negligence standard." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208 (1975).

The district court held that the Underwriters had established due diligence as a matter of law and, accordingly, issued summary judgment against the plaintiffs on the section 11 and 12(2) claims. On appeal, the plaintiffs contend that due diligence is so fact-intensive that summary judgment is inappropriate even where underlying historical facts are undisputed. The plaintiffs further contend that, in any event, the district court erred by ignoring disputed issues of material fact in this case. We hold that, in appropriate cases, summary judgment may resolve due diligence issues but that, in this case, the district court erred by granting summary judgment in favor of the Underwriters on several claims.

A.

The plaintiffs first argue that "due diligence . . . [and] the reasonableness of the defendants' investigation . . . is a question for the jury, even on undisputed facts." We agree, of course, that summary judgment is generally an inappropriate way to decide questions of reasonableness because "the jury's unique competence in applying the 'reasonable man' standard is thought ordinarily to preclude summary judgment." *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 450 n.12 (1975). We have, however, squarely rejected the contention that "reasonableness is *always* a question of fact which precludes summary judgment." *West v. State Farm Fire & Casualty Co.*, 868 F.2d 348, 350 (9th Cir. 1989) (emphasis added). Rather, reasonableness "becomes a question of law and loses its triable character if the undisputed facts leave no room for a reasonable difference of opinion." *Id.* Accordingly, "reasonableness [is] appropriate for determination on [a] motion for summary judgment when only one conclusion about the conduct's reasonableness is possible." *Id.* at 351. *See TSC Indus.*, 426 U.S. at 450 (summary judgment proper where "reasonable minds cannot differ") (internal quotation omitted).

Courts therefore may resolve questions of due diligence in those cases where no rational jury could conclude that the defendant had not acted reasonably. Several courts have, in fact, done just that. *See Weinberger*, ¶ 95,693 at 98,255 (summary judgment in favor of underwriters); *In re Avant-Garde Computing, Inc. Sec. Litig.*, No. 85-4149 (AET), 1989 WL 103625 at *7-*9 (D.N.J. Sept. 5, 1989) (summary judgment in favor of outside director); *Laven v. Flanagan*, 695 F. Supp. 800, 811-12 (D.N.J. 1988) (summary judgment in favor of outside directors); *cf. Bamco 15 v. Buchanan Residential Real Estate Ltd. Partnership*, [1986-87] Fed. Sec. L. Rep. (CCH) ¶ 93,062 at 95,285-86

(S.D.N.Y. 1986) (summary judgment in favor of *plaintiff* where defendant produced no evidence of due diligence).

The district court, therefore, properly held that "the adequacy of due diligence may be decided on summary judgment when the underlying historical facts are undisputed." *Toolworks I,* 789 F. Supp. at 1496.

B.

The plaintiffs next assert that, even if summary judgment may resolve due diligence issues in some cases, the district court erred in this case because three "hotly disputed" issues of material fact preclude summary judgment on the question of the Underwriters' due diligence. We consider each in turn.

1.

The plaintiffs first argue that the Underwriters failed to investigate properly Toolworks' Nintendo business. Specifically, the plaintiffs assert that the Underwriters should have discovered that, in contravention of statements in the prospectus, Toolworks had lowered prices on its Nintendo games and had "sold" significant inventory on a consignment basis, giving buyers an unqualified right to return unsold merchandise. *See WOW II,* slip op. at ____ ("a company that substantially overstates its revenues by reporting consignment transactions as sales makes false or misleading statements of material fact") (quotations omitted).

The district court disagreed, noting that the Underwriters had obtained written representations from Toolworks and Deloitte that the prospectus was accurate, had confirmed with Toolworks' customers that the company did not accept returns of non-defective cartridges, and had surveyed retailers to ensure that the company had not lowered its prices. *Toolworks I,* 789 F. Supp. at 1497. Thus, the court con-

cluded that the Underwriters had, as a matter of law, "performed a thorough and reasonable investigation of Toolworks' Nintendo business." *Id.* For the following reasons, we agree.

a.

The plaintiffs argue that the prospectus was false and misleading because it stated that Toolworks' "Nintendo software products have not been subject to price reductions," when, in fact, Toolworks had begun a price-cutting promotion days before the offering. The plaintiffs, however, presented no direct evidence that the Underwriters knew of this promotion. Indeed, the record illustrates that Toolworks' management consistently assured the Underwriters that the company would not reduce prices. [*See* ER 279:31; ER 280:12; USER 281/Buoy 288; USER 281/Sherry 267]. The plaintiffs nevertheless assert that summary judgment was inappropriate because a jury might infer that the Underwriters knew about the price cuts because Toolworks' management discussed the promotion while on a private plane with the Underwriters. All personnel who were on the plane, however, testified that no conversations regarding price cutting reached the Underwriters. As such, any inference that the Underwriters knew about the sales would not be based in fact and would be unreasonable. *See Weinberger*, ¶ 95,693 at 98,255. The district court properly granted summary judgment in favor of the Underwriters on this issue.

b.

The plaintiffs also claim that the prospectus was false and misleading because it stated that Toolworks "does not currently provide any product return rights to its retail Nintendo customers," when, in fact, the company had booked several consignment sales prior to the offering.

Again, however, the plaintiffs offered no direct evidence that the Underwriters knew about the sales, which represented a significant departure from prior Toolworks' policy. In fact, the record illustrates that the Underwriters made a substantial effort to ascertain Toolworks' return policy, both before and after the consignment sales occurred. The plaintiffs nevertheless assert that circumstantial evidence permits an inference that the Underwriters knowingly "watered down" the prospectus' risk-disclosure statement about merchandise returns and ignored a memorandum from one Toolworks customer ("Walmart") describing an unlimited right-of-return. This argument, however, misconstrues the full record.

In the process of drafting the prospectus, the Underwriters did change the risk-disclosure statement. An original draft stated that, "[i]n light of increased competition among the [Nintendo] entertainment titles on the market, it may be necessary for [Toolworks] to modify its return policy." [ER 289/322:22]. The final version stated only that "[t]here can be no assurance that [Toolworks] will not be subject to product returns in the future." [ER 289/15:8]. This change, however, is not sufficient to permit a reasonable inference that the Underwriters knew or should have known that Toolworks actually had changed its return policy. In fact, the Underwriters changed the disclosure statement in direct response to assertions by Toolworks' management that the company would never offer return rights and that the prospectus as originally written could prompt customers to seek such concessions in the future. [ER 317/Cartmell:136].

Moreover, although the Underwriters did receive a memorandum from Walmart describing an unqualified right to return non-defective merchandise, [ER 289/11], the record illustrates that Walmart never actually had such rights. Upon receiving the Walmart memorandum, the Underwrit-

ers called the retailer and confirmed that the statement regarding returns was erroneous (it should have said that Walmart had an unqualified right to return *defective* merchandise). [*See* ER 317/Sherry:252; USER 334/Zuckerman:89]. Thus, in light of this correction, the fact that the actual contract between Toolworks and Walmart provided only for the return of defective items, and the fact that Walmart never returned any undamaged products, an inference that the Underwriters attempted to conceal Toolworks' return policy would be unreasonable. The district court properly granted summary judgment in favor of the Underwriters on this issue.

2.

The plaintiffs next assert that a material issue of fact exists regarding whether the Underwriters diligently investigated, or needed to investigate, Toolworks' recognition of OEM revenue on its financial statements. The plaintiffs claim that the Underwriters "blindly rel[ied]" on Deloitte in spite of numerous "red flags" indicating that the OEM entries were incorrect and that, as a result, the district court erred in granting summary judgment.

An underwriter need not conduct due diligence into the "expertised" parts of a prospectus, such as certified financial statements. Rather, the underwriter need only show that it "had no reasonable ground to believe, and did not believe . . . that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." 15 U.S.C. § 77k(b)(3)(C); *see WOW II*, slip op. at ____. The issue on appeal, therefore, is whether the Underwriters' reliance on the expertised financial statements was reasonable as a matter of law.

a.

As the first "red flag," the plaintiffs point to Toolworks' "backdated" contract with Hyosung, a Korean manufacturer. During the fourth quarter of fiscal 1990, Toolworks recognized $1.7 million in revenue from an OEM contract with Hyosung. In due diligence, the Underwriters discovered a memorandum from Hyosung to Toolworks stating that Hyosung had "backdated" the agreement to permit Toolworks to recognize revenue in fiscal 1990. [ER 283:11]. The plaintiffs claim that, after discovering this memorandum, the Underwriters could no longer rely on Deloitte because the accountants had approved revenue recognition for the transaction.

If the Underwriters had done nothing more, the plaintiffs' contention might be correct. The plaintiffs, however, ignore the significant steps taken by the Underwriters after discovery of the Hyosung memorandum to ensure the accuracy of Deloitte's revenue recognition. The Underwriters first confronted Deloitte, which explained that it was proper for Toolworks to book revenue in fiscal 1990 because the company had contracted with Hyosung in March, even though the firms did not document the agreement until April. [ER 283:12-13]. The Underwriters then insisted that Deloitte reconfirm, in writing, the Hyosung agreement and Toolworks' other OEM contracts. [ER 283:12-13]. Finally, the Underwriters contacted other accounting firms to verify Deloitte's OEM revenue accounting methods. [ER 278:13].

Thus, with regard to the Hyosung agreement, the Underwriters did not "blindly rely" on Deloitte. The district court correctly held that, as a matter of law, the Underwriters' "investigation of the OEM business was reasonable." *Toolworks I,* 789 F. Supp. at 1498.

b.

The plaintiffs next assert that the Underwriters could not reasonably rely on Deloitte's financial statements because Toolworks' counsel, Riordan & McKinzie, refused to issue an opinion letter stating that the OEM agreements were binding contracts. This contention has no merit because, contrary to the plaintiffs' assertions, Toolworks had never requested the law firm to render such an opinion. [ER 317/Sylvester:36-42]. The plaintiffs attempt to infer wrongdoing in such circumstances is patently unreasonable. The district court correctly granted summary judgment in favor of the Underwriters on this issue.

c.

Finally, the plaintiffs assert that, by reading the agreements, the Underwriters should have realized that Toolworks had improperly recognized revenue. Specifically, the plaintiffs claim that several of the contracts were contingent and that it was facially apparent that Toolworks might not receive any revenue under them. As the Underwriters explain, this contention misconstrues the nature of a due diligence investigation:

> [The Underwriters] reviewed the contracts to verify that there was a written agreement for each OEM contract mentioned in the Prospectus — not to analyze the propriety of revenue recognition, which was the responsibility of [Deloitte]. Given the complexity surrounding software licensing revenue recognition, it is absurd to suggest that, in perusing Toolworks' contracts, [the Underwriters] should have concluded that [Deloitte] w[as] wrong, particularly when the OEM's provided written confirmation.

We recently confirmed precisely this point in a case involving analogous facts: "[T]he defendants relied on

Deloitte's *accounting decisions* (to recognize revenue) about the sales. Those expert decisions, which underlie the plaintiffs' attack on the financial statements, represent precisely the type of 'certified' information on which section 11 permits non-experts to rely." *WOW II*, slip op. at _____; *see also In re Worlds of Wonder Sec. Litig.*, 814 F. Supp. 850, 864-65 (N.D. Cal. 1993) ("It is absurd in these circumstances for Plaintiffs to suggest that the other defendants, who are not accountants, possibly could have known of any mistakes by Deloitte. Therefore, even if there are errors in the financial statements, no defendant except Deloitte can be liable under Section 11 on that basis.") [*WOW I*], *aff'd in relevant part by* WOW II, slip op. at _____.

Thus, because the Underwriters' reliance on Deloitte was reasonable under the circumstances, the district court correctly granted summary judgment on this issue. See *Toolworks I*, 789 F. Supp. at 1498 ("Given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise.").

3.

The plaintiffs next attack the Underwriters' due diligence efforts for the period after Toolworks filed a preliminary prospectus and before the effective date of the offering.[2] During this time, several significant events transpired. First, *Barron's* published a negative article about Toolworks that questioned the company's "aggressive accounting." [ER 289/22]. Second, in response to the *Barron's* article, the

[2]The Underwriters' contention that the events of this period are inapplicable to sections 11 and 12(2) liability is clearly incorrect. Both statutory provisions require disclosure of information needed in order to make a prospectus truthful and not misleading. As the Underwriters' own experts testified, poor first quarter earnings prior to the effective date of the offering would definitely constitute material information and would have to be disclosed.

SEC initiated a review of Toolworks' prospectus. [ER 341/Weeks:32-33]. Third, Toolworks sent two letters responding to the SEC. And, fourth, Toolworks booked several consignment sales that made the company appear to have a prosperous quarter, thereby ensuring success of the offering.

The district court held that the Underwriters satisfied their due diligence obligations during this period primarily by relying on Toolworks' representations to the SEC. *Id.* at 1497-98. For the following reasons, we conclude that disputed issues of material fact exist regarding the Underwriters' efforts and, accordingly, we reverse and remand for a trial on the merits.

a.

The plaintiffs first contend that the Underwriters should have done more to investigate the *Barron's* allegations of slumping sales and improper accounting. The Underwriters established, however, that they contacted a representative of Nintendo and several large retailers to confirm the strength of the market in response to the *Barron's* article. Moreover, as explained above, the Underwriters' reliance on Deloitte's accounting decisions was reasonable as a matter of law. Summary judgment was appropriate on this issue.

b.

Next, the plaintiffs raise the issue of Toolworks' July 4, 1990 letter to the SEC, which described the company's June quarter performance. [ER 316/2006]. In the letter, Toolworks represented that, although preliminary financial data was not available, Toolworks anticipated revenue for the quarter between $21 and $22 million. The plaintiffs claim that Toolworks deliberately falsified these estimates and that the Underwriters knew of this deceit.

The Underwriters claim that they were not involved in drafting the July 4 SEC letter and that, as a result, they have no responsibility for its contents. The plaintiffs presented evidence, however, that the letter was a joint effort of all professionals working on the offering, including the Underwriters. In fact, a Riordan & McKinzie partner specifically testified that, "[w]hen the letter finally went to the SEC, all parties had been involved in the process of creating it. There had been conference calls discussing it and comments and changes made by a lot of different members of the working group." [ER 317/Weeks:40-41]. Others similarly testified that the Underwriters were actively involved in discussions of how to respond to the SEC's inquiries regarding the June quarter. [*See* ER 317/Barker:23-24; ER 317/Sylvester:18-19].

The Underwriters argue that, even if they participated in initial discussions about the letter, they never knew that Toolworks' financial data actually was available and that, as a result, they could not have known that the letter (and the prospectus) were misleading. Given the Underwriters participation in drafting both documents, however, we think this is an unresolved issue of material fact. A reasonable factfinder could infer that, as members of the drafting group, the Underwriters had access to all information that was available and deliberately chose to conceal the truth. We therefore hold that summary judgment was inappropriate on this issue.

c.

After suffering lagging sales in the first two months of the June quarter, Toolworks booked several large consignment sales in late June, the quarter's final month, thereby enabling the company to meet its earning projections. [ER 289/:300:MB10048-49; ER 289/33; ER 289/502; ER 289/505]. Toolworks later had to reverse more than $7

million of these sales in its final financial statements for the quarter. [ER 322:20-26]. The plaintiffs presented evidence that the Underwriters knew that Toolworks had performed poorly in April, that Toolworks had no orders for the month as of June 8, that the June quarter is traditionally the slowest of the year for Nintendo sales, and that the late June sales accounted for more revenue than the cumulative total of Toolworks' Nintendo sales for the prior two and a half months. For its due diligence investigation of these sales, however, the Underwriters did little more than rely on Toolworks' assurances that the transactions were legitimate. A reasonable inference from this evidence is that Toolworks fabricated the June sales to ensure that the offering would proceed and that the Underwriters knew, or should have known, of this fraud. As a result, we conclude that summary judgment regarding the Underwriters' diligence on this issue was also inappropriate. *See Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 582 (E.D.N.Y. 1971) ("Tacit reliance on management is unacceptable; the underwriters must play devil's advocate.").

C.

Thus, we hold that the district court properly granted summary judgment in favor of the Underwriters on the section 11 and 12(2) issues regarding their due diligence investigation into Toolworks' Nintendo sales practices and description of OEM revenue. The district court erred, however, by granting summary judgment on the section 11 and 12(2) claims regarding the July 4 SEC letter and Toolworks' June quarter results. We remand for a trial on the merits of those claims.

III.

We next consider the plaintiffs' claims against the Underwriters and Deloitte under section 10(b) and Rule 10b-5 of

the 1934 Act, which provide liability for deceptive conduct in connection with the sale of securities. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. To establish liability under section 10(b), the plaintiffs must show that the defendants acted with scienter, "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder,* 425 U.S. at 193 n.12. The plaintiffs may establish scienter by proving either actual knowledge or recklessness. *E.g., Hollinger v. Titan Capital Corp.,* 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied,* 499 U.S. 976 (1991). In this context, "recklessness" is conduct "involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 1569 (internal quotation omitted).

The district court granted summary judgment in favor of the Underwriters and Deloitte, holding that the defendants had not acted with scienter as a matter of law. *Toolworks I,* 789 F. Supp. at 1498-1510. Summary judgment on the scienter issue is appropriate only if "there is no rational basis in the record for concluding that any of the challenged statements was made with the requisite scienter." *Schneider v. Vennard (In re Apple Computer Sec. Litig.),* 886 F.2d 1109, 1117 (9th Cir. 1989), *cert. denied,* 496 U.S. 943, (1990). We conclude that disputed issues of material fact exist and, as a result, we reverse and remand several of the claims under section 10(b).

A.

The plaintiffs raise the same issues against the Underwriters under section 10(b) as under sections 11 and 12(2). Because we conclude that the Underwriters acted with due diligence in investigating Toolworks' Nintendo business and OEM revenues, we also hold that the Underwriters did not

act with scienter regarding those claims. Therefore, the only section 10(b) issue involving the Underwriters is whether disputed issues of material fact exist regarding the July 4 SEC letter or the June quarter financial statements. We hold that they do.

The plaintiffs presented no evidence of the Underwriters' actual knowledge or fraudulent intent on these issues. As noted above, however, the evidence permits a reasonable inference that "the Underwriters had access to all information that was available and deliberately chose to conceal the truth" about figures in the July 4 SEC letter, *supra* page 2786, and that "the Underwriters knew, or should have known, of th[e] [alleged] fraud" in the June quarter statements, *supra* page 2786-87. This evidence is sufficient to defeat summary judgment on the scienter issue. We therefore remand for trial on these section 10(b) claims.

B.

Regarding Deloitte, the plaintiffs allege that the accountants violated section 10(b) by improperly computing the financial statements included in Toolworks' prospectus, by assisting Toolworks in drafting misleading letters to the SEC, and by enabling Toolworks to issue false financial statements for the June quarter. We consider each contention in turn.

1.

Toolworks included in the prospectus financial statements for fiscal 1990, which had been certified by Deloitte. The plaintiffs allege that Deloitte violated section 10(b) by improperly describing Toolworks' OEM revenues and by failing to discover Toolworks' price reductions and return policies. We disagree.

a.

In the district court, Deloitte conceded that the plaintiffs had raised a genuine issue of material fact as to whether the prospectus properly accounted for the OEM revenues. *Toolworks I,* 789 F. Supp. at 1504. Deloitte, however, contends that the plaintiffs presented no evidence that would support an inference of scienter with regard to this issue. The plaintiffs presented no direct evidence that Deloitte knew or recklessly disregarded errors in the financial statements. The plaintiffs did, however, produce circumstantial evidence with which they seek to infer that Deloitte acted with scienter. For example, the plaintiffs established that the OEM agreements were poorly documented, informal, and conditional [ER 297/Kumaria:439], that the OEM licensing transactions were risky [ER 296/851], that Toolworks' management was under "extraordinary pressure" for favorable earnings [ER 297/956], and that Deloitte obtained only oral confirmations of some agreements [ER 271:9] and deviated from their audit plan in reviewing the contracts [ER 295:27-28].

The district court found this evidence insufficient to support an inference of scienter. The court noted that Deloitte had reviewed the OEM documentation, obtained oral and written confirmation of the agreements from Toolworks' management, confirmed in writing most of the OEM agreements with outside vendors, obtained and reviewed Toolworks' licensing agreements, and reviewed the progress of Toolworks' collections on the OEM agreements. *Id.* at 1505. The court concluded that "[t]hese procedures provided Deloitte with ample support for the audit conclusions it reached. . . . Plaintiffs' contention . . . that Deloitte should have performed further inquiries and investigations, arguing with the benefit of hindsight, does not establish that the [ ] audit was reckless." *Id.* We agree.

"[T]he proof of scienter in fraud cases is often a matter of inference from circumstantial evidence." *Herman & MacLean v. Huddleston,* 459 U.S. 375, 390 n.30 (1982). However, "[t]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." *WOW II,* slip op. at ____ (quotations omitted); *see, e.g., The Limited, Inc. v. McCrory Corp.,* 645 F. Supp. 1038, 1045 (S.D.N.Y. 1986) (errors in a client's financial statements do not give rise to an inference of fraud on the part of the auditor). Rather, "[s]cienter requires more than a misapplication of accounting principles. The plaintiff must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the same decisions if confronted with the same facts." *WOW II,* slip op. at ____ (quotations omitted).

In this case, the plaintiffs have not satisfied this standard. At most, the evidence establishes that Deloitte was negligent in auditing Toolworks, not that Deloitte recklessly or knowingly falsified the financial statements. The plaintiffs' expert, Albert Rossi, does not help their case. Although Rossi testified that Deloitte "knew that the OEM agreements did not meet Toolworks' or GAAP's requirements for revenue recognition," [ER 295:33-34], he provided no factual basis for these allegations of knowledge by Deloitte. As a result, his testimony merely "consists of self-righteous statements that, because Deloitte did not audit [Toolworks] as he would have done, Deloitte must have acted fraudulently. Such evidence is not sufficient." *Id.* at 1427; *see WOW I,* 814 F. Supp. at 871 n.15 ("this is not the first time that a district court has awarded summary judgment to an auditor on the scienter issue in the face of a declaration by Rossi").

We therefore affirm the district court's summary judgment on the OEM revenue issue.

b.

The plaintiffs also claim that Deloitte should have included in the 1990 financial statements a description of Toolworks' return and price protection policies. Deloitte correctly notes, however, that Toolworks did not grant return rights or price guarantees until fiscal 1991, after the 1990 audit was complete. The plaintiffs presented no evidence that Deloitte knew, or should have known, that Toolworks would change its policies. In fact, Toolworks acquired the Nintendo business only at the very end of fiscal 1990. [ER 296/15:F-9]. The failure of Deloitte to include statements about Toolworks' not-yet-implemented return and pricing policies does not give rise to a reasonable inference of scienter. *See Laven,* 695 F. Supp. at 812 ("summary judgment can be granted if plaintiff fails to present credible evidence of *scienter*"). The district court's summary judgment in favor of Deloitte on this issue was therefore appropriate.

2.

The plaintiffs next contend that Deloitte violated section 10(b) by participating in drafting the two letters that Toolworks sent to the SEC.[3] As noted above, the plaintiffs allege

[3]The district court analyzed this issue in terms whether Deloitte was liable for "aiding and abetting" Toolworks' primary violation of section 10(b). *See Toolworks I,* 789 F. Supp. at 1507-09. After the district court issued its opinion, however, the Supreme Court concluded that aiding and abetting liability does not exist under section 10(b). *See Central Bank v. First Interstate Bank,* 114 S. Ct. 1439 (1994).

Despite *Central Bank,* we nevertheless consider this issue because the plaintiffs' complaint clearly alleges that Deloitte is primarily liable under

that the letters falsely stated that Toolworks did not have preliminary financial data available for the June quarter and misleadingly described the nature of Toolworks' OEM contracts.

a.

On July 3, 1990, the SEC told Toolworks that it should disclose "preliminary results" for the June quarter in the prospectus. [ER 316/35]. In its July 4 response, Toolworks stated that "[p]reliminary financial data is not now available," but that the company "anticipated" revenues for the quarter to range between $21 and $22 million. [ER 316/2006]. Toolworks, however, had acknowledged to the professionals participating in the offering that some financial data for the quarter actually was available. [ER 317/Weeks:77-82]. The plaintiffs allege that, as a result, the statement to the SEC was a deliberate falsehood and that Deloitte violated section 10(b) by suggesting in the July 4 SEC letter that preliminary data was not available and by acquiescing to financial projections which they knew, or should have known, to be false. We agree for the same reasons that we have reversed the summary judgment in favor of the Underwriters on this issue. Specifically, we conclude that "[a] reasonable factfinder could infer that, as members of the drafting group, [Deloitte] had access to all information that was available and deliberately chose to conceal the truth" about Toolworks' poor June quarter

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section 10(b) for the SEC letters. In fact, the July 1 SEC letter stated that it "was prepared after extensive review and discussions with . . . Deloitte" and actually referred the SEC to two Deloitte partners for further information. [ER 296:234]. Similarly, the plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter. [ER 317/Weeks:40-41]. This evidence is sufficient to sustain a primary cause of action under section 10(b) and, as a result, *Central Bank* does not absolve Deloitte on these issues.

performance, *supra* page 2786. Summary judgment was inappropriate on this issue.

b.

In its July 1 letter to the SEC, Toolworks attached a "model" OEM agreement for the SEC to review. [ER 296/234]. The plaintiffs claim that the letter was false and misleading because the model agreement differed from the agreements that Toolworks actually used. We agree.

The model OEM agreement stated that "in no event shall the OEM be relieved from any minimum payment obligations." [ER 296/234]. Only four of Toolworks's actual OEM contracts, however, contained such language. Because only a small portion of the total OEM contracts included the "model" language, Deloitte should have known that the model agreement was false and misleading, and inclusion of the model agreement in the July 1 SEC letter gives rise to a reasonable inference that Deloitte knew or recklessly disregarded this falsehood. Deloitte claims that it did not draft, or even see, the model agreement and cannot therefore be liable for it. Deloitte, however, ignores the fact that the misleading language of the model agreement was actually quoted in the body of the July 1 SEC letter itself, which Deloitte admittedly saw. [ER 296/234:6]. We hold that summary judgment was therefore inappropriate as to this issue.

3.

Finally, the plaintiffs allege that Deloitte violated section 10(b) by enabling Toolworks to issue preliminary financial statements for the June quarter. *See Toolworks I*, 789 F. Supp. at 1506-07. The plaintiffs admit, however, that "[a]s to the[se] quarterly financial statements, the Complaint [only] charged Deloitte with aiding and abetting"

Toolworks' primary violation of section 10(b). As a result, under *Central Bank* the plaintiffs' claims are no longer viable. *Central Bank,* 114 S. Ct. at 1455 ("a private plaintiff may not maintain an aiding and abetting suit under § 10(b)"). We therefore affirm the district court's summary judgment in favor of Deloitte on this issue.

C.

In summary, we conclude that, although the district court properly granted summary judgment in favor of the Underwriters and Deloitte on most of the section 10(b) claims, summary judgment was inappropriate on the issues regarding the SEC letters and Toolworks' June quarter results. We remand those claims.

IV.

The district court properly granted summary judgment in favor of the Underwriters on the section 11 and 12(2) claims regarding Toolworks' Nintendo sales and OEM accounting. The court erred, however, by ignoring disputed issues of material fact regarding the Underwriters' due diligence investigation of Toolworks' financial performance in the June quarter and the description of that performance in the July 4 SEC letter. Summary judgment was inappropriate on those issues.

Furthermore, the district court properly granted summary judgment in favor of the Underwriters on all the section 10(b) claims other than those arising from the July 4 SEC letter and the June quarter statements. The court also properly granted summary judgment in favor of Deloitte on the section 10(b) claims regarding recognition of OEM revenues in the audited financial statements appended to the prospectus. The district court erred, however, in granting summary judgment in favor of Deloitte on the section 10(b)

claims regarding the SEC letters and Toolworks' unaudited financial statements for the June quarter.

We therefore affirm in part, reverse in part, and remand for further proceedings consistent with this opinion.

AFFIRMED in part. REVERSED in part. REMANDED

APPENDIX B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

In re SOFTWARE TOOLWORKS, INC.
SECURITIES LITIGATION

This document relates to:

ALL ACTIONS

No. C-90-2906 FMS

ORDER REGARDING SUMMARY JUDGMENT CROSS-MOTIONS

FERN M. SMITH, District Judge.

In this securities class action, class plaintiffs ("Plaintiffs"), defendant underwriters Montgomery Securities and PaineWebber, Inc. ("Underwriters") and defendant auditor Deloitte & Touche ("Deloitte"), move the Court for summary judgment or partial summary judgment as follows: (1) Plaintiffs move for partial summary judgment against the Underwriters as to liability on Plaintiffs' Section 11 and 12(2) claims; (2) Underwriters move for summary judgment on all claims against them; (3) Plaintiffs move for partial summary judgment against Deloitte as to Section 11 and 10(b), and Rule 10b-5, liability on three issues; (4) Deloitte moves for summary judgment on all claims against it, or alternatively, for partial summary judgment as

to any of the Section 11 and 10(b), and Rule 10b-5, claims against it.

On December 31, 1991 the Court issued a tentative Order on the various cross-motions and scheduled a hearing. A hearing was held on February 14, 1992. The Court now issues its final Order, discussing the cross-motions in corresponding pairs; that is, (1) Plaintiffs vs. Underwriters and (2) Plaintiffs vs. Deloitte.[1] Relevant factual and evidentiary information will be incorporated and discussed as pertinent to each motion.

PLAINTIFFS VS. UNDERWRITERS

Plaintiffs seek partial summary judgment against the Underwriters as to liability on Plaintiffs' Section 11 and 12(2) claims. The Underwriters seek summary judgment on all claims against them — i.e., Plaintiffs' Section 11, 12(2) and 10(b) claims against them.[2] Summary judgment is appropriate if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c).[3] A dispute about a material fact is "genuine," "if the evidence is such that a reasonable jury could return a verdict

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[1] Plaintiffs and Deloitte have also filed motions to strike certain evidence pertaining to the Plaintiffs vs. Deloitte motions. Said motions to strike will be addressed, if and when appropriate, with the corresponding substantive motions.

[2] For convenience, claims under Section 10(b) and Rule 10b-5 are collectively referred to as "Section 10(b) claims."

[3] The standards and procedures for summary judgment and partial summary judgment are the same. Schwarzer, Tashima & Wagstaffe, *Federal Civil Procedure Before Trial* § 14:33 (1991).

for the nonmoving party." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986).

In order for Plaintiffs to attain summary judgment they must establish that summary judgment is appropriate as to every element of their securities claims. If the Underwriters can raise a genuine factual dispute as to any element — falsity, materiality, etc. — then the Plaintiffs' motion must be denied. *Id.* By contrast, the Underwriters can obtain summary judgment by defeating any one of those elements. Since defeating any one element will not only afford summary judgment to the Underwriters, but will also necessarily decide Plaintiffs' motion, the Court will first address the Underwriters' motion.

I. UNDERWRITERS' MOTION FOR SUMMARY JUDGMENT

The Underwriters seek summary judgment on Plaintiffs' Section 11, 12(2) and 10(b) claims against them. According to the Underwriters, the evidence in the record indisputably demonstrates that their investigation in relation with the Registration Statement and Prospectus ("Prospectus") for Toolworks' July 1990 public offering ("Offering") satisfied the due diligence standard, and therefore exempts them from Section 11 or 12(2) liability. The Underwriters further claim that they are entitled to summary judgment on the Section 10(b) claims because Plaintiffs cannot prove the necessary scienter to establish primary or secondary liability under Section 10(b). Plaintiffs respond that the Underwriters cannot justify summary judgment since the evidence on the record: (1) establishes that the Prospectus was materially false and misleading and that the Underwriters failed to make a reasonable investigation of the accuracy of the

Prospectus,[4] and (2) raises triable issues of fact with respect to Plaintiffs' Section 10(b) claims.

For the reasons set forth below, and after a full hearing and an exhaustive review of the facts and evidence presented by the parties, the Underwriters' motion for summary judgment is GRANTED and Plaintiffs' motion for partial summary judgment is DENIED.

A. Prospectus Claims

Section 11 affixes liability to underwriters of stock by means of a prospectus which is materially misleading, unless they prove they exercised due diligence to discover and eliminate such false and misleading statements. *Herman & MacLean v. Huddleston,* 459 U.S. 375, 382 (1983); 15 U.S.C. § 77k. Similarly, an underwriter who offers or sells a security by means of a prospectus which contains a material misstatement or omits a material fact is liable under Section 12(2), unless he establishes an affirmative due diligence defense. 15 U.S.C. § 771(2).[5] The standards under Sections 11 and 12(2) are therefore virtually the same. *See Sanders v. John Nuveen & Co.,* 619 F.2d 1222, 1228 (7th Cir. 1980), *cert. denied,* 450 U.S. 1005 (1981).[6]

Without conceding any elements of Plaintiffs' prima facie case on the Prospectus claims, the Underwriters seek summary judgment solely on the issue of due diligence. They claim that the investigation they performed in connection with the Offering entitles them to the "due diligence" defense. *See, e.g., Feit v. Leasco Data Processing Equipment*

[4] In other words, that Plaintiffs are entitled to partial summary judgment on the Section 11 and 12(2) claims.

[5] Unlike Section 10(b) and Rule 10b-5, Section 11 and 12(2) liability does not require proof of scienter. See 15 U.S.C. §§ 77k(a) & 771 (2).

[6] For convenience, claims under Section 11 and 12(2) will be collectively referred to as the "Prospectus claims."

Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) (absolving underwriters on ground of due diligence). Plaintiffs contend that the Underwriters cannot establish a due diligence defense because there is substantial evidence that the Underwriters failed to perform a reasonable investigation into (1) Toolworks' Nintendo business, (2) the results of the June 1990 quarter, and (3) recognition of revenues on Toolworks' Original Equipment Manufacture ("OEM") software licensing business. Plaintiffs further claim that it is not proper to decide the adequacy of due diligence on summary judgment, because what constitutes a reasonable investigation is a mixed question of law and fact for the jury to decide.

1. Deciding the Adequacy of Due Diligence on Summary Judgment

What is a factual and what is a legal question for purposes of summary judgment is not easily determined. *See Pullman-Standard, Division of Pullman, Inc. v. Swint,* 456 U.S. 273, 288 (1982). At one extreme, the resolution of disputes over historical facts (a thing done, an action performed, or an event or occurrence) is a factual question for the jury. At the other extreme, when the facts material to the application of a pure rule of law are undisputed, the application is a matter of law for the court, requiring no trial. In between these extremes, there is a large continuum occupied by mixed questions of law and fact.

Mixed questions of law and fact generally require the resolution of disputes over historical facts, a matter for the jury. When the dispute is not over historical facts, however, but over their legal significance, the issue may be appropriate for summary judgment. *See Horton v. Taylor,* 767 F.2d 471, 478 (8th Cir. 1985); Schwarzer, *Summary Judgment Under the Federal Rules: Defining Genuine Issues of Material Fact,* 99 F.R.D. 465, 472-73 (1984). After a careful review of the record, the Court finds that there are no

genuine issues of material historical fact with regard to the Underwriter's due diligence defense. The disagreement between Plaintiffs and the Underwriters revolves around whether the due diligence performed was enough to entitle the Underwriters to a statutory defense under Section 11 and 12(2).

The "application of standards set by statutes, regulations and precedent to undisputed facts will normally give rise to a 'question of law' for the court. That principle ensures that the law is applied in a uniform and predictable fashion." *U.S. v. Rule Industries, Inc.*, 878 F.2d 535, 542 (1st Cir. 1989); *see also McDermott Int'l, Inc. v. Wilander*, 111 S. Ct. 807, 818 (1991); *Stissi v. Interstate and Ocean Transport Co.*, 765 F.2d 370, 374 (2d Cir. 1985). The Court, however, must decide whether the context in which the question arises makes it more appropriate for decision by judge or by jury. *See, e.g., Rule Industries, Inc.*, 878 F.2d at 542 (Buy American Act presents rare instance where determination of statutory standard better suited for jury).

A decision likely to have significant precedential impact on the resolution of an issue imbued with the need for consistency and reasoned resolution is generally better suited for determination by the judge than the jury. The Supreme Court has stated, albeit in the context of allocation between trial and appellate courts, that "[r]egarding certain largely factual questions in some areas of the law, the stakes — in terms of impact on future cases and future conduct — are too great to entrust them finally to the judgment of the trier of fact." *Bose Corp. v. Consumers Union of U.S.*, 466 U.S. 485, 501 n.17 (1984). The question of the due diligence defense in securities cases is such an issue.

First, the due diligence defense is a statutory standard; as such, its application to undisputed historical facts should normally be a matter for the judge. *See Rule Industries, Inc.*,

878 F.2d at 542. This ensures that the administration of the statutory defense benefits from consistency, uniformity and predictability. *Id.* Second, a decision on the due diligence defense generally affects a class of persons (as opposed to one person), making it in the nature of judicial rule making. *See, e.g., Columbia Pictures Industries, Inc. v. Professional Real Estate Investors, Inc.*, 866 F.2d 278 (9th Cir. 1989) (court decides as a matter of law that the renting of movies by a hotel to its patrons does not violate Copyright Act, an evaluative question that arguably is proper for a jury except that it potentially affects a large segment of the public); see also Keeton, *Legislative Facts and Similar Things: Deciding Disputed Premise Facts*, 73 Minn. L. Rev. 1, 20 (1988). Third, knowledge of what constitutes due diligence does not fall within the common experience of jurors, making it instead a question better suited for the judge. *See, e.g., R.C. Dick Geothermal Corp. v. Thermogenics, Inc.*, 890 F.2d 139, 143 (9th Cir. 1989) (geographical boundaries of a market present a question of law since boundaries dispute involve esoteric cost-benefit analysis, an inquiry beyond the straightforward finding of historical facts or common sense judgment for which juries are best suited). Fourth, leaving the question of what constitutes due diligence to the jury will lead to a battle of experts. While this may be appropriate in some cases, with a question like due diligence, the inquiry does not lend itself to any objective standards. The experts, who basically become paid advocates, will simply express an opinion based on their own subjective viewpoints, which will be biased by their role. The jurors will then be forced to decide between these paid advocates. The resulting uncertainty will increase litigation against deep pocket defendants (such as underwriters) and encourage collusion between plaintiffs and the issuer, who will often be in a precarious financial situation already. These policy implications favor summary judgment as the preferred means of resolution. *See, e.g., Anderson v. Creighton*, 483 U.S. 635, 641, 646

(1987) (qualified immunity may be decided as a matter of law because of public policy concern to protect government agents from submitting to pretrial discovery); *Collins v. Nagle*, 892 F.2d 489, 494-95 (6th Cir. 1989) (probable cause for arrest and reasonableness of force proper for summary judgment where case turns on policy determination and there is no material dispute over what transpired); *Dellums v. U.S. Nuclear Regulatory Comm'n*, 863 F.2d 968, 971 n.5 (D.C. Cir. 1988) (causation decided on summary judgment when primarily a decision on policy). Finally, treating due diligence as a question of law, once the historical facts are undisputed, will apportion the risk more appropriately, encourage settlement at early stages and lead to more equitable and consistent results.

The Court therefore finds that the adequacy of due diligence may be decided on summary judgment when the underlying historical facts are undisputed. *See also Weinberger v. Jackson*, [1990-91 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,693 at 98,255-56, 1990 WL 260676 (N.D. Cal. 1990) [hereinafter *Weinberger*]; *Laven v. Flanagan*, 695 F. Supp. 800, 811-12 (D.N.J. 1988).

2. Applying the Due Diligence Standard

Section 11 and 12(2) require a "reasonable" investigation by the Underwriters. *Weinberger* at 98,255; 15 U.S.C. §§ 77k(b)(3) & 77l(2). This does not, as Plaintiffs imply, require an audit on the part of the Underwriters. Underwriters cannot "be expected to possess the intimate knowledge of corporate affairs of inside directors, and their duty to investigate should be considered in light of their more limited access." *Feit*, 332 F. Supp. at 582. Accordingly, underwriters may reasonably rely on SEC letters and documents (*see Feit*, 332 F. Supp. at 583 (underwriter entitled to rely on issuer's counsel's letter to SEC)), as well as on representations of management. *See Weinberger* at 98,255-06 (underwriters may rely on management's repre-

sentations after several meetings and other verification). That is not to say that underwriters may "tacit[ly] rel[y] on management assertions" (*Feit*, 332 F. Supp. at 582); rather, underwriters may rely on management's representations when it is reasonable to do so under the circumstances. It would be unreasonable, for example, to solely rely on management's representations when said representations could have been reasonably verified. *See Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 696-97 (S.D.N.Y. 1968). It is not unreasonable, however, to rely on management's representations with regard to information that is solely in the possession of the issuer and cannot be reasonably verified by third parties. Underwriters cannot be expected to ferret out everything that management knows about the company; they only need to reasonably attempt to verify and believe the accuracy of the information in the prospectus. If the Underwriter's overall investigation was reasonable under the circumstances, they are entitled to a due diligence defense. *See Weinberger* at 98,255.

a. Did Underwriters Perform a Reasonable Investigation of the Nintendo Business?

Plaintiffs contend that the Underwriters failed to perform sufficient due diligence on Toolworks' Nintendo business, particularly with regards to the company's policy on product returns and price protection. The Court disagrees. The Underwriters interviewed over a dozen Toolworks and Mindscape officials, exploring all aspects of Toolworks' business. They then verified management's representations by contacting three major Nintendo customers, the distributors of Toolworks' PC software, three major software developers or licensees, and customers of the Priority subsidiary. They also contacted Nintendo of America regarding the health of the Nintendo market, inspected the factory where Miracle Piano was being manufactured, subjected Toolworks' fiscal 1991 budget to line-by-line scrutiny and re-

viewed its financial statements with Deloitte.[7] The Underwriters even obtained written representations from Toolworks and selling stockholders that the Prospectus was accurate, as well as a comfort letter from Deloitte.

The Underwriters specifically confirmed with Toolworks' customers that they could not return non-defective Nintendo cartridges and surveyed Nintendo retailers (through Pillsbury, Madison & Sutro and John Weiss) to confirm no price-cutting on Toolworks' Nintendo products. They also properly followed up any "negative or questionable information [that] developed as a result of their investigation." *Weinberger* at 98,255. When an article in the June 18, 1990 issue of Barron's questioned the health of the Nintendo market, for example, the Underwriters again contacted senior executives at Nintendo of America and were assured that the Nintendo market was holding as expected.[8] Also, when the Underwriters discovered a memo suggesting that Walmart could return working cartridges, they followed up and confirmed that the memo was an error and that Walmart could in fact only return defective cartridges.[9] The Underwriters did not solely rely on the word of management (*see Escott*, 283 F. Supp. at 697); they performed a thorough and reasonable investigation of Toolworks' Nintendo business, which is reflected in the extensive risk warnings contained in the Prospectus.[10]

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[7]Pillsbury, Madison & Sutro reviewed Toolworks' contracts, Board minutes, and similar documents.

[8]Toys R Us also informed John Weiss, the Montgomery analyst who followed Toolworks, in early July that Nintendo cartridge and hardware sales were increasing.

[9]Walmart, in fact, never returned any undamaged games.

[10]The Prospectus sets out several risk factors such as warning of the Company's dependence on Nintendo, "the general seasonal nature of the consumer software industry," potential retail oversupply of cartridges, "no assurance that the Company will not be subject to product

b. Did Underwriters Perform a Reasonable Investigation on the June Quarter Results?

Plaintiffs contend that the Underwriters failed to properly investigate Toolworks' June quarter results. The Court disagrees. The Underwriters repeatedly asked Toolworks about the quarter and were told that the only risk involved was whether cartridge orders due in June would arrive in time.[11] The Underwriters further received representation from Toolworks and Toolworks' outside auditors and counsel that, although preliminary results were not available, the results for the June quarter appeared to be satisfactory and consistent with expectations. Toolworks' counsel further represented to the SEC that the results for the quarter would be satisfactory. The Underwriters reasonably relied on such representations, particularly on the representations by the issuer and its counsel to the SEC. See *Feit,* 332 F. Supp. at 583.

c. Description of the OEM Business

The description of Toolworks' OEM business in the Prospectus was "expertised" by Deloitte. Underwriters may reasonably rely on expertised financial statements. 15 U.S.C. § 77k(b)(3)(C); *see In re Gap Stores Securities Litigation,* 79 F.R.D. 283, 297-98 (N.D. Cal. 1978); *Escott,* 283 F. Supp. at 687-97. Given the complexity of the accounting issues, the Underwriters were entitled to rely on Deloitte's expertise. The Underwriters, however, did not

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returns in the future," as well as "no assurance that the Company's recently introduced or planned products will achieve market acceptance." Prospectus at 6-8, 26. These warnings, along with many others in the Prospectus, may, by themselves, entitle the Underwriters to summary judgment. *See In re Convergent Technologies Securities Litigation,* 948 F.2d 507, 515-16 (9th Cir. 1991); *I. Meyer Pincus & Assocs., P.C. v. Oppenheimer & Co.,* 936 F.2d 759, 763 (2d Cir. 1991).

[11]Toolworks, Deloitte and Toolworks' counsel later stated that the cartridges had arrived on time and had been shipped to customers.

solely rely on Deloitte. They reviewed confirmations from each OEM, demanded a reconfirmation from Hyosung, and confirmed Toolworks' OEM revenue recognition policy with other accounting firms.[12] Their investigation of the OEM business was reasonable.

As a result of the overall investigation and due diligence, the Underwriters reasonably believed the accuracy of the information contained in the Prospectus. They had no knowledge of any misrepresentation or omission, nor had they reason to disbelieve any of the representations made to them. The Prospectus in fact reflects that where serious risks were unveiled or suspected, warnings were issued.[13] This Court therefore finds that the Underwriters conducted a reasonable investigation under the circumstances and are accordingly entitled to a due diligence defense.[14]

Summary judgment is therefore GRANTED in favor of the Underwriters with respect to Plaintiffs' Section 11 and 12(2) claims.[15]

B. Section 10(b) Claims

1. Primary Liability

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[12]The Underwriters also properly relied on the statements to the SEC by Toolworks' counsel concerning the basis for the OEM revenue recognition. See *Feit*, 332 F. Supp. at 583.

[13]*See supra* note 11.

[14]Plaintiffs' contention that had the Underwriters done more, they would have revealed problems, is not persuasive. The Court cannot evaluate an underwriter's due diligence defense with the benefit of hindsight. The overall investigation performed here was reasonable under the circumstances at the time of the investigation.

[15]Plaintiffs' motion for partial summary judgment against the Underwriters as to liability on Plaintiffs' Section 11 and 12(2) claims is necessarily DENIED.

Section 10(b) liability requires a showing of scienter — a mental state embracing intent to deceive, manipulate, or defraud. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 1621 (1991). Scienter may be satisfied either by proof of actual knowledge or by proof of recklessness. *Id.* at 1568-69. The reckless conduct necessary to satisfy the scienter requirement is conduct "involving not merely simple, or inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Id.* at 1569 (citations omitted).

The Underwriters contend that there is no evidence that they knew of any material misstatements in the Prospectus and assert that they cannot be held reckless since they performed a reasonable due diligence investigation. They also contend that scienter cannot be proved as to their projections issued immediately after the Offering. Plaintiffs respond that there is compelling evidence that the Underwriters had actual knowledge of material facts which were omitted or misrepresented in the Prospectus and in letters to the SEC, or recklessly closed their eyes to obvious facts which should have alerted them to the truth. Plaintiffs also respond that there is evidence that the Underwriters recklessly issued projections of Toolworks' June quarter results on the roadshow and in reports issued following the Offering.

Scienter may properly be decided on summary judgment. See *Weinberger* at 98, 255-56; *see also In re Apple Computer Securities Litigation*, 886 F.2d 1109, 1117-18 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990). The Underwriters may obtain summary judgment by simply showing that there is a failure of proof concerning scienter — an essential element of Plaintiffs' claim. *Anderson v. Liberty Lobby, Inc.*,

477 U.S. 242, 257 (1986). Plaintiffs, on the other hand, must produce "specific facts" sufficient to establish the existence of scienter (*Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986)); speculative inferences drawn from circumstantial evidence will not necessarily do. *See, e.g., Rose v. Wells Fargo & Co.*, 902 F.2d 1417, 1422-23 (9th Cir. 1990). Where, as here, there is absence of any motive, there exists a pattern inconsistent with scienter, or there is economic implausibility, plaintiffs bear a heavy burden in defeating summary judgment with inferences from circumstantial evidence. *See Apple Computer*, 886 F.2d at 1118 (no inference where defendants' overall pattern of conduct was inconsistent with scienter); *California Architectural Bldg. Products, Inc. v. Franciscan Ceramics, Inc.*, 818 F.2d 1466, 1470-71 (9th Cir. 1987) (no inference where fraud implausible), *cert. denied*, 484 U.S. 1006 (1988); *Goldberg v. Household Bank, F.S.B.*, 890 F.2d 965, 967 (7th Cir. 1989) (same); *Ochs v. Shearson Lehman Hutton, Inc.*, 768 F. Supp. 418, 427-28 (S.D.N.Y. 1991) (strong showing required absent a motive).[16] In other words, Plaintiffs are

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[16]Plaintiffs offer no motive for the Underwriters to participate in the alleged fraud, except to point to the fees that they earned from the Offering. This Court has previously stated that an allegation that professionals committed fraud in order to obtain professional fees is not a persuasive motive to establish scienter. June 18, 1991 Order at 8-10, 1991 WL 319033. In fact, the risk of monumental damages against underwriters if found liable for securities fraud more than balances the temptation of ill-gotten gains and makes such a motive implausible. An underwriter's "greatest asset is its reputation for careful work. Fees for [an offering] could not approach the losses [the underwriting firm] would suffer from a perception that it would muffle a client's fraud." *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990). Nor do the actions of the Underwriters support a pattern consistent with scienter. The extensive risk warnings in the Prospectus, for example, negate any inference of scienter. *See Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1516 (N.D. Cal. 1990). If the Underwriters had intended to mislead investors, they would not

not entitled to the benefit of the doubt with respect to inferences from circumstantial evidence — only reasonable and non-speculative inferences under the circumstances of the case need be accepted. *See In re Coordinated Pretrial Proceedings*, 906 F.2d 432, 441 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 2274 (1991).[17]

As the Court previously found, the Underwriters carried out a reasonable investigation on all aspects of Toolworks, including those subjects alleged to be misrepresented or omitted. The Underwriters diligently investigated the condition of Toolworks' Nintendo business, OEM revenue recognition, and the June quarter results. Their actions with respect to these alleged misrepresentation or omissions cannot be considered reckless. *Weinberger* at 98,255-56. Nor have Plaintiffs, as the following analysis shows, provided "specific facts" sufficient to establish (or reasonably infer under the circumstances of this case) that the Underwriters knew of any material misstatements or omissions.

a. Condition of Toolworks' Nintendo Business

Plaintiffs claim that the Underwriters knew that the Nintendo market had become hit driven, seasonal and competitive. This is true. The Underwriters, however, did not hide this fact; instead, they made sure to explicitly disclose these changes in the Prospectus. Plaintiffs also claim that Underwriters knew that no Nintendo titles were

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have included such warnings, which could have discouraged investors from purchasing Toolworks stock. The overall circumstances make Plaintiffs' claim against the Underwriters implausible; Plaintiff must accordingly "come forward with more persuasive evidence to support their claim than would otherwise be necessary." *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986).

[17] Plaintiffs are nonetheless entitled to have any direct evidence taken as true. *See In re Coordinated Pretrial Proceedings*, 906 F.2d at 440-41. They, however, only offer speculative inferences from circumstantial evidence against the Underwriters.

selling well, that there was a glut of retail inventory, and that Toolworks' largest customers were reducing or eliminating purchases. Plaintiffs' evidence in support of these assertions, however, is not sufficient to infer scienter in this case. Plaintiffs' expert's opinion of what the Underwriters likely did or did not know is far from what is required to infer scienter under the circumstances of this case. *See, e.g., Ochs v. Shearson Lehman Hutton, Inc.*, 768 F. Supp. at 427-28.[18]

b. OEM Revenue Recognition

Plaintiffs offer no evidence that the Underwriters knew that Toolworks' financial statements improperly recognized OEM revenue. Instead, Plaintiffs contend that certain "red flags" were so suspicious that the Underwriters' awareness of them amounts to scienter. "Aroused suspicions," however, "do not constitute actual awareness of one's role in a fraudulent scheme." *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1128 (5th Cir. 1988), *cert. denied*, 492 U.S. 918 (1989). To establish that a party "intended to violate the securities laws, plaintiffs must prove more than that the [defendants] recklessly ignored danger signals." *Id.* The Court has already found that the Underwriter's due diligence into Toolworks' OEM business establishes that they were not reckless.

c. False Statements Regarding June Quarter Results

Plaintiffs attempt to infer from circumstantial evidence that the Underwriters knew at the time of the Offering that Toolworks' June quarter results were poor. Plaintiffs contend that the Underwriters should have been suspicious of representations made by Toolworks' auditors and lawyers, because Toolworks reported poor results for April (the first month of the quarter), and that the Underwriters knew that

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[18] Additionally, the Underwriters' follow-up investigations repeatedly revealed that Toolworks' games were not in trouble.

preliminary financial data was available for the quarter.[19] "Should have," however, is not the standard; the Underwriters can be liable only if they had actual knowledge or if their alleged misconduct rose to a level of recklessness. *Weinberger* at 98,255. The Court has already determined that the Underwriters' diligent investigation of the June quarter results cannot constitute recklessness, and now finds that the evidence proffered to infer actual knowledge of poor preliminary financial data for the June quarter falls short of that required to defeat summary judgment in this case. *See, e.g., California Architectural Bldg. Products*, 818 F.2d at 1470 (evidentiary burden for inference is heavy where fraud implausible).[20]

Finally, Plaintiffs fail to produce sufficient evidence to establish scienter with respect to the analyst reports issued by John Weiss and Lee Igsur. A projection or forecast may be considered false or misleading only where: (1) the statement is not genuinely believed, (2) there is no reasonable basis for the belief, or (3) the speaker is aware of undisputed facts tending seriously to undermine the accuracy of the statements. *Apple Computer,* 886 F.2d at 1113; *see also In re Convergent Technologies Securities Litigation*, 948 F.2d 507, 517 (9th Cir. 1991) (opinions and predictions in research reports that have sufficient factual and/or histor-

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[19] Plaintiffs primarily rely on a July 2, 1990 internal Toolworks spreadsheet to support their assertion that the Underwriters knew that preliminary financial data was available for the June quarter. Plaintiffs, however, present no evidence that the Underwriters saw the document or were aware of it. They instead contend that actual knowledge be inferred from this evidence.

[20] Plaintiffs also fail to proffer sufficient evidence to establish the necessary scienter for their allegation that the Underwriters were reckless in their roadshow projections. The Underwriters' projections were reasonably based on representations made to them by the issuer and its auditor and lawyers (*see Feit*, 332 F. Supp. at 583); their conduct cannot be considered reckless.

ical basis are not actionable). Financial projections made in good faith are per se not made with scienter. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) (no liability unless defendant "acted other than in good faith"). John Weiss and Lee Igsur have attested to their good faith belief in the accuracy of their earning estimates. There is no evidence that they knew of any facts not disclosed in their reports that would "seriously undermine" the accuracy of their reports. Plaintiffs offer of circumstantial evidence to infer scienter under these circumstances will simply not do.[21]

2. Secondary Liability

a. Conspiracy Allegations

This Court has held that for Plaintiffs to prevail on their conspiracy claim, they must provide "specific facts showing 'an agreement to participate in an unlawful act.' " June 18, 1991 Order at 9, 1991 WL 319033 (*quoting Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1520 (N.D. Cal. 1990)). The Ninth Circuit's recent definition of the showing of recklessness necessary to establish primary liability under Rule 10b-5 (*Hollinger*, 914 F.2d at 1569-70) does not, as Plaintiffs incorrectly suggest, alter this requirement. *See In re ASK Sec. Litig.*, No. C-85-20207(A)-WAI, slip op. at 10, 1991 WL 138334 (N.D. Cal. Mar. 11, 1991) (rejecting proposition that recklessness may satisfy the scienter requirement for secondary liability). Nothing in Hol-

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[21] Plaintiffs claim, without any persuasive evidence, that Weiss and Igsur are not entitled to an independent analysts report standard because they were not in fact independent. Even if the Court accepted Plaintiffs' argument, the Court's conclusion would not change. Weiss and Igsur reasonably relied on representations made by the issuer and its auditor and lawyers in issuing their reports (*see Feit*, 332 F. Supp. at 583); their conduct cannot be considered reckless.

linger overrules settled precedents holding that conspiracy requires proof of an agreement.[22]

Plaintiffs offer no evidence of an agreement by the Underwriters to enter into a conspiracy with Toolworks. Plaintiffs instead offer speculative inferences that a conspiracy existed. This will not do in this case. *See, e.g., Richards v. Neilsen Freight Lines*, 810 F.2d 898, 902 (9th Cir. 1987) (speculative inferences of conspiracy will not help).

b. Aiding and Abetting Allegations

Aiding and abetting liability requires proof of actual knowledge of the primary wrong and substantial assistance in committing it. *Jett v. Sunderman*, 840 F.2d 1487, 1495 (9th Cir. 1988). Plaintiffs offer no evidence that the Underwriters knew that any of the statements made by Toolworks were false, nor that the Underwriters substantially assisted in the fraud by soliciting the Kleiber and Turzo reports. Plaintiffs fail to establish their burden under *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986).

Summary judgement is therefore GRANTED in favor of the Underwriters with respect to Plaintiffs' Section 10(b) claims.

PLAINTIFFS VS. DELOITTE

Plaintiffs seek partial summary judgment against Deloitte as to Section 11 and 10(b) liability on three issues. Deloitte seeks summary judgment on all claims against it or, alternatively, partial summary judgment as to any of the Section 11 and 10(b) claims against it. As previously noted, Plaintiffs must establish that summary judgment is appropriate as to

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[22]Nor does anything in Hollinger purport to overrule settled precedents holding that aiding and abetting requires actual knowledge. *See, e.g., Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1520 (N.D. Cal. 1990) (aiding and abetting requires actual knowledge).

every element of their securities claims in order to attain summary judgement. If Deloitte can raise a genuine factual dispute as to any element, Plaintiffs' motion must be denied. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 248 (1986). Deloitte, by contrast, can obtain summary judgment by defeating any one element of Plaintiffs' claims. Since defeating any one element will not only afford summary judgment to Deloitte, but will also necessarily decide Plaintiffs' motion, the Court will first address Deloitte's motion.

I. DELOITTE'S MOTION FOR SUMMARY JUDGMENT

Deloitte seeks summary judgment on Plaintiffs' Section 11 and 10(b) claims against it. According to Deloitte, it is entitled to summary judgment on the Section 10(b) claims because Plaintiffs cannot prove the necessary scienter to establish primary or secondary liability under Section 10(b). Deloitte further claims that the evidence in the record indisputably demonstrates that their investigation in relation with the audited March 31, 1990 financial statements ("March 31, 1990 Financial Statements") included in the Prospectus satisfied the due diligence standard, and therefore exempts it from Section 11 liability. Plaintiffs respond that Deloitte cannot justify summary judgment since the evidence on the record: (1) raises triable issues of fact with respect to Plaintiffs' Section 10(b) claims, and (2) establishes that the Prospectus was materially false and misleading and that Deloitte failed to make a reasonable investigation of the accuracy of the financial statements included in the Prospectus.[23]

For the reasons set forth below, and after a full hearing and an exhaustive review of the facts and evidence presented

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[23] In other words, that Plaintiffs are entitled to partial summary judgment on the Section 11 claims.

by the parties, Deloitte's motion for summary judgment is hereby GRANTED IN PART AND DENIED IN PART.

A. Section 10(b) Claims

1. Primary Liability

Liability under Section 10(b) requires (1) a material misstatement or omission, (2) in connection with the purchase or sale of a security, (3) scienter, and (4) reliance. *Basic, Inc. v. Levinson,* 485 U.S. 224, 231 (1988). As previously noted, scienter may be satisfied either by proof of actual knowledge or by proof of recklessness. *Hollinger,* 914 F.2d at 1568-69.

Deloitte contends that Plaintiffs offer no evidence of scienter (nor in some instances of materiality) with respect to Plaintiffs' allegations that Deloitte is primarily liable under Section 10(b) for: (a) alleged misrepresentations in the March 31, 1990 Financial Statements and (b) alleged misrepresentations by a Deloitte partner to a securities analyst from Piper Jaffray & Hopwood.[24] Plaintiffs respond, not surprisingly, by asserting that there is ample evidence to establish scienter. The Court must therefore decide whether Plaintiffs produce "specific facts" sufficient to establish the existence of scienter (*Celotex Corp. v. Catrett,* 477 U.S. 317, 322 (1986)), without considering speculative or inconclusive inferences drawn from circumstantial evidence. *See Apple Computer,* 886 F.2d at 1118 (no inference where defendants' overall pattern of conduct was inconsistent with scienter); *California Architectural Bldg. Products, Inc. v. Franciscan Ceramics, Inc.,* 818 F.2d 1466, 1470-71 (9th Cir. 1987) (no inference where fraud implausible), *cert. denied,* 484 U.S. 1006 (1988); *Ochs v. Shearson Lehman*

[24] Deloitte's materiality arguments will be addressed where appropriate.

Hutton, Inc., 768 F. Supp. 418, 427-28 (S.D.N.Y. 1991) (strong showing required absent a motive).[25]

a. March 31, 1990 Financial Statements

(1) Nintendo Business

Plaintiffs allege that the March 31, 1990 Financial Statements improperly included: (a) in revenue, sales of three Nintendo titles which Deloitte knew, or was reckless in not knowing, Toolworks would have to issue price protection allowances on; (b) in revenue, sales of these titles to three distributors who Deloitte knew, or was reckless in not knowing, would exercise their right to return the slow moving Nintendo titles; and (c) in inventory, slow-moving and obsolete Nintendo titles, which Deloitte knew, or was reckless in not knowing, would have to be written down.

(a) Price Protection

Deloitte contends that it is entitled to summary judgment on this issue because Plaintiffs offer no evidence to establish that the price protection granted in late June (without Deloitte's knowledge) had any material effect on the March 31, 1990 Nintendo sales. According to Deloitte, the alleged misrepresentations are not material since over 70% of the company's fiscal 1990 sales of Nintendo games were

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[25] As with the Underwriters, Plaintiffs offer no persuasive motive for Deloitte to participate in the alleged fraud, Deloitte's actions do not support a pattern consistent with scienter, and the overall circumstances make Plaintiffs' claim against Deloitte implausible. *See supra* note 16. Plaintiffs must accordingly "come forward with more persuasive evidence to support their claim than would otherwise be necessary." *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587, (1986); *but cf. In re Coordinated Pretrial Proceedings*, 906 F.2d 432, 441 (9th Cir. 1990), *cert. denied*, 111 S. Ct. 2274 (1991) (Matsushita only applies to plausibility of inferences from circumstantial evidence).

sales of Paperboy, an unqualified hit as to which Toolworks has never granted any price protection. A determination of materiality is a fact-specific issue "which should ordinarily be left to the trier of fact." *Apple Computer,* 886 F.2d at 1113. But where, as here, the moving party puts forth a valid argument and no evidence is presented to rebut it, the non-moving party fails to establish its burden under Celotex, and summary judgment is therefore appropriate.

Furthermore, Plaintiffs fail to offer sufficient evidence to establish the existence of scienter. Deloitte contends that Toolworks repeatedly represented to it that Toolworks' policy was not to allow price protection, and that Deloitte did not learn about any price protection offered on the three relevant Nintendo titles until long after the Offering. Plaintiffs note that Deloitte reviewed a draft of the Prospectus in May 1990 which included language that the company might have to modify its return policy. According to Plaintiffs, this language should have indicated to Deloitte that the Nintendo business was in trouble and should have caused Deloitte to expand its audit procedures. "Should have" is not the standard; Deloitte can be liable only if it had actual knowledge or if the alleged misconduct rose to a level of recklessness. *Weinberger* at 98,255. Speculative inferences from circumstantial evidence as to what Deloitte may have known and what audit procedures it should have taken, are far from the showing required to support Plaintiffs' claim that Deloitte had actual knowledge of any price protection,[26] or that Deloitte's conduct was such an extreme departure from ordinary care that Deloitte "must have been aware" of the danger of misleading the public. *Hollinger,* 914 F.2d at 1569.[27]

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[26] *See supra* note 25.

[27] Nor are Plaintiffs' arguments that Deloitte should have performed all the audit steps it contemplated in its initial planning memorandum persuasive. Deloitte made a reasoned determination to modify its audit

b. Sales to Three Distributors

Deloitte claims that these sales did not take place in fiscal 1990 and are not reflected in any way in Toolworks' audited March 31, 1990 Financial Statements. Plaintiffs offer no evidence to rebut this claim and accordingly fail to meet their burden under Celotex.

c. Nintendo Inventory

Deloitte contends that there is no evidence that any of Toolworks' 1990 Nintendo inventory was ever sold below cost and that the amount of 1990 Nintendo inventory was so minuscule that there could not have been a material overstatement.[28] Plaintiffs offer no evidence to rebut either argument and accordingly fail to meet their burden under Celotex.

2. Mindscape Software Reserve

Plaintiffs claim that the March 31, 1990 Financial Statements improperly included obsolete Mindscape computer software in inventory which Deloitte knew, or was reckless in not knowing, should have been written down to the lower of cost or market; in other words, the inventory reserve should have been higher than stated. Deloitte contends that

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plan, as accountants often do. An unwise determination may rise to professional malpractice, but cannot be considered reckless in or of itself. Recklessness requires such an extreme departure from ordinary care that Deloitte "must have been aware" of the danger of misleading the public. *Hollinger,* 914 F.2d at 1569. Here, Deloitte focused on the issue, made inquiries, and evaluated the information received. The revised audit was admittedly less thorough than the first proposed audit, but cannot be considered reckless. *See Weinberger* at 98,255.

[28] Toolworks' 1990 financial statements reported $4.8 million in company-wide inventory. Of that total, only about $300,000 (less than 1% of the total assets of $37.029 million) consisted of Nintendo cartridges. That small amount, Deloitte argues, would have been immaterial even if it should have been written down to zero.

whether the inventory should have been written down was a matter of judgment on which Plaintiffs disagree, not a basis on which to infer scienter. The Court agrees. Deloitte made diligent inquiries regarding Mindscape's inventory reserve and reasonably relied on representations regarding said reserve. Deloitte took a conservative position with respect to Mindscape inventory; for example, it passed on booking any reductions to the reserve, contrary to Toolworks' suggestions, when it thought it would be inappropriate.[29] Plaintiffs offer no evidence to rebut this; instead, they second guess Deloitte's decision that a 44% reserve was appropriate — this is not enough to infer scienter in this case. *See Apple Computer*, 886 F.2d at 1118 (no inference where defendants' overall pattern of conduct was inconsistent with scienter).[30]

3. Mindscape Development and Royalty Costs

Plaintiffs claim that Deloitte improperly included in revenue Mindscape royalty advances and guarantees; as a result, revenues were overstated by material amounts. Deloitte contends that Plaintiffs offer no admissible evidence of a material overstatement or of scienter to support their claims. The Court agrees. Plaintiffs' expert's bare conclusory statements are insufficient to defeat summary judgment. *See Taylor v. List*, 880 F.2d 1040, 1045 (9th Cir. 1989);

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[29]Toolworks represented to Deloitte that it believed its Mindscape reserves were overstated by as much as $1 million, and suggested that the reserves be reversed by that amount.

[30]Nor are Plaintiffs' expert's conclusory statements sufficient to defeat summary judgment. *See Taylor v. List*, 880 F.2d 1040, 1045 (9th Cir. 1989); *Bulthuis v. Rexall Corp.*, 789 F.2d 1315, 1318 (9th Cir. 1985); *see also In re Adobe Systems, Inc. Securities Litigation*, 787 F. Supp. 912, 919-920 (N.D. Cal. March 17, 1992) (expert's declaration cannot defeat summary judgment when evidence in record directs to the contrary).

Bulthuis v. Rexall Corp., 789 F.2d 1315, 1318 (9th Cir. 1985).

4. OEM Revenue Recognition

Plaintiffs claim that some or all of the $11.1 million in OEM licensing revenue that Deloitte recognized in the March 31, 1990 Financial Statements was improperly recorded, and that Deloitte knew, or was reckless in not knowing, that such misstatements took place.[31] Deloitte concedes that there is a genuine issue of material fact as to whether OEM licensing revenue recognized in fiscal 1990 was properly stated, but contends that the undisputed facts preclude a finding that Deloitte acted with scienter. It notes, correctly, that errors in a client's financial statements do not, by themselves, give rise to an inference that the auditor committed fraud. *See The Limited, Inc. v. McCrory Corp.*, 645 F. Supp. 1038, 1045 (S.D.N.Y. 1986).

Deloitte has shown that it performed extensive procedures with respect to Toolworks' OEM revenue recognition. After reviewing Toolworks' revenue recognition policy for OEM licensing revenues and clearing it with the SEC, Deloitte: (1) requested and reviewed the documentation supporting the recognition of the OEM revenue; (2) made extensive inquiries of and obtained specific written and oral representations from management; (3) confirmed in writing the timing, terms and minimum guarantee of every significant OEM transaction; (4) obtained a second written confirma-

[31] During fiscal 1990, Toolworks entered into agreements under which it licensed to OEMs the right to reproduce and sell certain software developed by Toolworks and/or by other developers. Under these agreements, minimum amounts were payable to the company over periods generally not exceeding 24 months. Toolworks' revenue recognition policy was, and is, to recognize the minimum amounts due as revenue when the company fulfills its obligations under the related agreements, which occurs when the company has delivered software and related documentation to the OEM in reproducible form.

tion from Hyosung after an issue arose concerning the timing of that agreement; (5) obtained oral confirmation from five of the six large OEM customers which confirmed without exception that Toolworks had satisfied all of its obligation prior to March 31, 1990; (6) obtained and reviewed over thirty third-party licensing agreements; (7) confirmed Toolworks' right to sublicense software directly with Borland, a major supplier of software that Toolworks licensed to OEMs; (8) obtained and reviewed information concerning actual cash collections on the OEM agreements, showing that Toolworks had already collected over $3 million on the agreements by June 1990; and (9) performed subsequent events procedures. These procedures provided Deloitte with ample support for the audit conclusions it reached in the March 31, 1990 Financial Statements.[32] Plaintiffs' contention (primarily through their expert's declaration) that Deloitte should have performed further inquiries and investigations, arguing with the benefit of hindsight, does not establish that the aforementioned audit was reckless. *See Weinberger* at 98,255-56.[33] Nor does pointing out a few instances when bits of negative information were presented to Deloitte establish actual knowledge or recklessness. All audits result in the discovery of some adverse or inconsistent information which must be evaluated. Deloitte has shown that when presented with negative information it investigated and acted upon it. The fact that on some occasions Deloitte concluded that the negative information presented was outweighed by contrary information might show bad judgment, but nothing Plaintiffs have put forth shows such an extreme departure from the stan-

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[32] Plaintiffs' objections to Alan Frank's declaration do not change this conclusion.

[33] Plaintiffs' arguments that Deloitte should have performed all the audit steps it contemplated in its initial planning memorandum are also insufficient to establish scienter. *See supra* note 27.

dards of ordinary care that Deloitte "must have been aware" of the danger of misleading the public. *Hollinger*, 914 F.2d at 1569.[34]

b. Piper Jaffray & Hopwood

Plaintiffs claim that Deloitte partner Alan Frank made false representations about Toolworks to Robert Kleiber of Piper Jaffray & Hopwood, who Deloitte knew was disseminating investment recommendations concerning Toolworks stock, so that Mr. Kleiber could prepare a positive report on Toolworks prior to the Offering. Deloitte contends that this allegation has no basis. Mr. Kleiber testified that he requested the call, only discussed OEM revenue policy with Mr. Frank in general terms and did not discuss writing an investment article on Toolworks. Plaintiffs' only evidence to support their claim is Mr. Frank's deposition testimony, which says no more than that he spoke with Mr. Kleiber about OEM revenue policy in general terms. This is not enough to infer scienter.

2. Secondary Liability

a. Aiding and Abetting Allegations

Aiding and abetting liability requires proof of: (1) an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the primary wrong and of his or her role in furthering it; (3) and substantial assistance in committing the wrong. *Jett v. Sunderman*, 840 F.2d 1487, 1495 (9th Cir. 1988). Defendants' conduct may satisfy the substantial assistance requirement "even though . . . [they] assisted in the scheme only by silence or inaction," if they had a duty to disclose knowledge that would be material to

[34] Furthermore, the fact that Deloitte often reduced revenue recognition when it discovered negative information is inconsistent with scienter. *See Apple Computer*, 886 F.2d at 1118.

investors. *DCD Programs, Ltd. v. Leighton*, 833 F.2d 183, 188 (9th Cir. 1987); *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973). Said duty to disclose arises from a "knowing assistance of or participation in a fraudulent scheme." *Harmsen v. Smith*, 693 F.2d 932, 944 (9th Cir. 1982), *cert. denied*, 464 U.S. 822 (1983).[35]

Plaintiffs allege Deloitte is liable for aiding and abetting under Section 10(b) for: (1) assisting in including improper transactions in Toolworks' unaudited financial statements for the quarter ended June 30, 1990, (2) assisting in making fraudulent representations to the SEC, and (3) knowingly preparing and lending its name and reputation to Toolworks' Prospectus that contained false financial statements and other false statements.

1. June 30, 1990 Quarter

Plaintiffs allege that Toolworks' earnings press release and its Form 10-Q for the quarter ended June 30, 1990 ("June 30, 1990 Quarter Statements") were false and misleading. Deloitte contends that whether or not the June 30, 1990 Quarter Statements were false and misleading is irrelevant for purposes of aiding and abetting liability because Deloitte had no knowledge of and did not assist Toolworks in including allegedly improper transactions in the company's unaudited June 30, 1990 Quarter Statements.[36] Plaintiffs must present sufficient evidence that Deloitte knew and substantially assisted the alleged misconduct in order to support their aiding and abetting claims.

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[35]Negligent conduct does not satisfy Section 10(b) scienter. *Burgess v. Premier Corp.*, 727 F.2d 826, 832 (9th Cir. 1984).

[36]Deloitte did not audit Toolworks' quarterly financial statements, or perform a quarterly review or any other kind of verification function in connection with the June 30 quarter.

a. Nintendo Sales to Distributors

Plaintiffs allege that Toolworks sold Nintendo cartridges to three distributors (Commtron, Capital Sales and Multi-Pal International) which were improperly included in Toolworks' revenue for the June 30 quarter because they were in some way contingent, non-final, or permitted a right of return. Deloitte contends that it did not review, approve, or otherwise participate in the company's decision to book these revenues, and that it did not know about these sales until after the class period. Plaintiffs respond that a consolidating trial balance and schedule of OEM revenues sent to Deloitte the day of or the day before Toolworks made its quarterly press release, "graphically illustrated that Toolworks' revenue and income [for the June 30, 1990 quarter] were phony." These documents, however, reflected what Toolworks reported in its unaudited June 30, 1990 Quarter Statements. They did not give any indication that the reported figures were "phony." Actual knowledge of the alleged fraud (primary wrong) cannot be inferred on Deloitte from these financial statements, particularly when Deloitte did not audit or review them.[37]

b. Price Protection

Plaintiffs allege that Deloitte knew that Toolworks had granted price protection to Nintendo customers during the June 30, 1990 quarter, in violation of its revenue policy. Deloitte contends that it had no knowledge that Toolworks granted any price protection to any of its Nintendo customers during the June 30, 1990 quarter.[38] Plaintiffs do no more

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[37]Nor is there any persuasive evidence to infer that Deloitte had actual knowledge of its role in furthering the alleged fraud or that Deloitte substantially assisted the fraud.

[38]Deloitte notes that all Toolworks defendants have served sworn interrogatory answers admitting that they did not inform Deloitte that Toolworks had granted price protection to Nintendo customers.

than argue that Deloitte should have done more audit work and that, if it had, it should have or would have learned about the price protection. This is not evidence that Deloitte knew of or substantially assisted the alleged fraudulent scheme.[39]

c. The Sony OEM Transaction

Plaintiffs allege that Toolworks improperly included $1.8 million in June 30, 1990 quarter revenue for an OEM transaction with Sony Corporation. Deloitte contends that it had no knowledge of any impropriety and that it did not assist Toolworks in booking this transaction.[40] Plaintiffs once again offer no more than an argument — i.e., that Deloitte should have had a heightened concern regarding the recognition of any OEM revenue. As just noted, this is not evidence that Deloitte knew of or substantially assisted in the alleged fraudulent scheme.

d. Reversal of Reserves

Plaintiffs allege that Deloitte knew of and participated in the reversal of reserves in order to manipulate Toolworks' June 30, 1990 quarter numbers. Deloitte contends it was not informed of and did not participate in Toolworks' decision to reverse June 30, 1990 reserves.[41] Plaintiffs respond that Deloitte should have discovered a discrepancy in the unaudited June 30, 1990 Quarter Statements that could have lead to the discovery that reserves had been reversed.

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[39] *See supra* note 25 and text accompanying note 26.

[40] Both the CFO and the Controller of Toolworks have testified that they did not consult or discuss with Deloitte the propriety of booking revenue for the transaction.

[41] All Toolworks officers who could remember participating in the decision to reverse the reserves have testified that Deloitte was not informed of and did not participate in Toolworks' decision.

This in no way rebuts the evidence presented by Deloitte that it had no knowledge of the reversal and that it did not substantially assist in it. Plaintiffs fail to establish their burden under Celotex.

2. SEC Letters

In late June and early July 1990, Toolworks' outside counsel, Riordan & McKinzie, sent a series of letters to the SEC responding to questions regarding the preliminary prospectus. Plaintiffs claim that these letters contained misrepresentations and omissions regarding two areas — (a) Toolworks' estimated revenues for the June 30, 1990 quarter, and (b) Toolworks' accounting for OEM licensing revenues — and that Deloitte aided and abetted the fraudulent scheme.

a. The June Estimate

The only statement in the SEC letters relating to the June quarter estimates is in Riordan & McKinzie's letter of July 4, 1990. According to Deloitte, the estimates referred to in the letter were generated entirely by Toolworks; Deloitte did not generate, approve, or otherwise perform any testing procedures on Toolworks' estimates. Deloitte admits, however, that it suggested textual changes to the first sentence of the paragraph regarding estimates, but that the revision actually served to clarify the preliminary nature of Toolworks' estimate of its June quarter results.[42]

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[42]The initial language of the first sentence of the draft letter provided: "The preliminary financial data available to the Company for the recently-ended first quarter of fiscal 1991 is tentative and subject to receipt of substantial additional confirming data, particularly with respect to overseas transactions." The final version of the letter sent to the SEC read: "Preliminary financial data is not now available with regard to the Company's recently ended first quarter of fiscal 1991, as the Company is in the process of completing its quarterly financial statement closing procedures."

Plaintiffs do not dispute that the issue concerns one sentence, but argue that the change perpetrated a fraud on the SEC.[43] Plaintiffs contend that the language was changed at the urging of Deloitte because of the concern that the SEC would ask to see the preliminary financial data which showed that Toolworks had lost $420,000 through June 25, 1990, but "miraculously" generated nearly $2 million in revenues during the last five days of the quarter. Plaintiffs, however, fail to provide sufficient evidence to support an aiding and abetting claim. They rely on testimony of Mr. Sylvester from Riordan & McKinzie, to support their claim that the change was made out of concern that the SEC would ask to see the preliminary financial data. But Mr. Sylvester's testimony only emphasizes Mr. Frank's concern that the SEC not be misled about the reliability of the preliminary information available to Toolworks, and that the letter be more "precisely and conservatively drafted." This does not imply actual knowledge or substantial assistance of a fraudulent scheme in this case. *See Apple Computer*, 886 F.2d at 1118.[44]

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[43] Plaintiffs argue, in addition to their sentence argument, that Deloitte aided and abetted a fraud by failing to disclose that Toolworks' June quarter estimates were incorrect. Deloitte, however, has established through direct and undisputed evidence that it did not generate, approve or otherwise test Toolworks' estimate. "Red flags" that should have alerted Deloitte to errors in the estimates cannot establish nor imply actual knowledge on the part of Deloitte.

[44] In addition, as Deloitte points out, Plaintiffs' theory makes little sense. While the final version of the letter said that "preliminary financial data" was not yet available, it also stated in the same paragraph that Toolworks' estimate was based on "the information presently available." Whether Toolworks' estimate was based on "preliminary financial data" or upon "information presently available" matters little; if the SEC had wanted to see the basis for Toolworks' estimate, it would have asked to see it under either version of the letter.

b. OEM Accounting

Deloitte performed extensive procedures and investigations in connection with its audit of Toolworks' March 31, 1990 Financial Statements.[45] On that basis, Deloitte believed in good faith that the statements concerning OEM accounting in the letters sent to the SEC by Riordan & McKinzie were accurate. Plaintiffs point out, however, two aspects of Riordan & McKinzie's letter of July 1, 1990 which they claim is the basis for their aiding and abetting claim against Deloitte: (1) the substance of a model OEM agreement attached to the letter, and (2) the supposed failure to disclose information about the Craftsman transaction.

1. Model OEM Agreement

Plaintiffs allege that the July 1, 1990 letter to the SEC was drafted in large part by Deloitte and contained an attached model OEM agreement which was not representative of the actual OEM agreements.[46] Deloitte contends that it did not draft, approve or review the model OEM agreement that was attached to the July 1 letter.[47] Plaintiffs offer no evidence to the contrary. Plaintiffs need more than mere

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[45] *See supra* text accompanying note 32.

[46] Plaintiffs note that the model OEM agreement contained language stating that "in no event shall the OEM be relieved from any guaranteed minimum payment obligation," whereas the actual OEM agreements under which Toolworks recognized revenue in the March 31, 1990 fiscal year contained no such language.

[47] Deloitte provided Riordan with a rough first draft of certain portions of the letter; Deloitte's initial draft, however, was substantially rewritten by Riordan, which took responsibility for drafting the final language.

speculation to create an inference of actual knowledge and substantial assistance.[48]

2. Craftsman Transaction

Plaintiffs allege that the statements in the July 1, 1990 letter were inaccurate in light of the Craftsman transaction. Plaintiffs claim that the letter represented that "the OEM has an unconditional legal obligation to pay the Company the scheduled minimum amount due under the terms of the contract" and that "the Company does not grant price changes or concessions to OEM customers under any circumstances," although Deloitte knew that Toolworks had, in at least one instance, relieved an OEM customer (Craftsman) from a guaranteed minimum payment obligation for the 1990 fiscal year. Plaintiffs ignore, however, the history behind the Craftsman transaction. Deloitte had earlier determined that the Craftsman deal was improperly recorded, and approached Toolworks to make an adjustment to reverse the revenue booked on this sale. When Toolworks refused, Deloitte posted an entry for the entire amount of the revenue recognized on this sale to its Schedule of Adjustments Passed.[49] Deloitte then analyzed its aggregate passed adjustments and concluded that they did not have a material effect on the March 31, 1990 Financial Statements taken as a whole. This is precisely what Deloitte was supposed to do under generally accepted auditing standards ("GAAS").

Plaintiffs' aiding and abetting claim is based on the argument that it is a material misrepresentation to disclose a

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[48] Plaintiffs also fail to establish a requisite primary violation. See Jett, 840 F.2d at 1495. This is perhaps indicative of the fact that their argument appears to be more a quibble with wording than an argument of substance.

[49] This is the schedule of proposed adjustments which Toolworks declined to make.

company's revenue recognition policy without also disclosing that there was an immaterial passed adjustment for a single transaction which failed to comply with that policy. This cannot be so. Every audit results in a certain number of passed adjustments which are not disclosed; these adjustments are passed as immaterial and accordingly require no disclosure. There is no indication that Deloitte did anything but follow this procedure in good faith; it cannot be held as an aider and abettor.

3. Prospectus

Plaintiffs claim that Deloitte should be held liable as an aider and abettor for certain alleged misrepresentations in the Prospectus. According to Plaintiffs, Deloitte knew about the false statements, but allowed use of its name in the Prospectus, thereby acquiring a duty to disclose facts that would be material to investors. Plaintiffs claim that pursuant to *Roberts v. Peat Marwick, Mitchell & Co.*, 857 F.2d 646 (9th Cir. 1988), Deloitte's subsequent failure to correct the misstatements "substantially assisted" in the fraud.

The Ninth Circuit acknowledged in Roberts that accountants who know of an alleged violation, but allow use of its name in offering memoranda despite that knowledge, may create a duty to disclose such information where the accountant's information is superior and the cost of disclosure to the accountant is minimal. *Id.* at 653. Plaintiffs must therefore establish knowledge on the part of Deloitte in order to create a possible duty of disclosure to satisfy the substantial assistance requirement.[50]

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[50]Roberts does not, as Plaintiffs appear to contend, stand for the proposition that the use of Deloitte's name in the Prospectus is per se substantial assistance. Whether Deloitte "knew of and substantially assisted in the wrong depends on the circumstances." *Roberts*, 857 F.2d at 653 (citation omitted).

Plaintiffs allege Deloitte aided and abetted two misrepresentations in the Prospectus. Plaintiffs first claim that merely disclosing Toolworks' revenue recognition policy for OEM transactions was misleading because Toolworks allegedly recognized OEM revenue in contravention of its policy — i.e., that Toolworks did not comply with its policy.[51] The Court has already found that there is no persuasive evidence of actual knowledge with respect to Plaintiffs' OEM revenue recognition claim against Deloitte.[52] Plaintiffs' first Prospectus aiding and abetting claim similarly fails for lack of scienter.

Plaintiffs also claim that the statement that "[c]urrently all sales of Nintendo products are final and the Company accepts the return of defective software cartridges" was false and misleading because contingent sales were made to three distributors in late June. Once again, the Court has already found that there is no persuasive evidence of actual knowledge with respect to contingent sales made to three distributors in late June 1990.[53] Plaintiffs' argument regarding unused draft Prospectus language does not alter this finding.[54] Plaintiffs' second Prospectus aiding and abetting claim also fails for lack of scienter.

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[51] Plaintiffs do not contend, nor does the Court construe, this aiding and abetting claim as arguing that Toolworks' OEM revenue recognition policy was different from the policy described in the Prospectus. In fact, all the direct evidence in the record confirms that Toolworks' revenue recognition policy was accurately reflected in the Prospectus.

[52] *See supra* Plaintiffs vs. Deloitte, Section I.A.1.a.4.

[53] *See supra* Plaintiffs vs. Deloitte, Section I.A.2.a.1.a.

[54] Plaintiffs argue that language to the effect that "it may be necessary for the Company to modify its return policy" was omitted from the Prospectus because Deloitte suggested that if the disclosure were made, Toolworks would have to establish Nintendo reserves. The evidence cited (Mr. Nate Cartell's testimony), however, does not imply scienter and is therefore insufficient to defeat summary judgment. Additionally,

b. Conspiracy Allegations

Liability for conspiring to violate the federal securities laws requires "specific facts showing 'an agreement to participate in an unlawful act.' " June 18, 1991 Order at 9, 1991 WL 319033 (quoting *Alfus v. Pyramid Technology Corp.*, 745 F. Supp. 1511, 1520 (N.D. Cal. 1990)). Plaintiffs offer no evidence of an agreement by Deloitte to enter into a conspiracy with Toolworks. Plaintiffs instead offer speculative inferences that a conspiracy existed. This will not do. *See, e.g., Richards v. Neilsen Freight Lines*, 810 F.2d 898, 902 (9th Cir. 1987) (speculative inferences of conspiracy will not help).

Summary judgement is therefore GRANTED in favor of Deloitte with respect to Plaintiffs' Section 10(b) claims.

B. Section 11 Claims

Section 11 limits an accountant's liability to a statement in a registration statement "which purports to have been prepared or certified by him." 15 U.S.C. § 77k(a)(4). An accountant may therefore be held liable only for those statements "expressly attributed to the accountant" on the face of the registration statement. *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 643 (N.D. Cal. 1980), modified on other grounds, 581 F. Supp. 878 (N.D. Cal. 1984).[55] Here, the only statement attributed to Deloitte in the Prospectus is Deloitte's audited March 31, 1990 Financial Statements. Deloitte is accordingly liable under Section 11 for any material misrepresentations or omissions in the March 31,

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the omitted language was not material since the Prospectus did say that "[t]here can be no assurances that the Company will not be subject to product returns in the future." Prospectus at 8.

[55] *Cf. Ahern v. Gaussoin*, 611 F. Supp. 1465, 1483 (D. Or. 1985) (subsequent events up to effective date of registration statement are relevant to show that financial statement was false or that it had become misleading).

1990 Financial Statements, unless it establishes an affirmative due diligence defense. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983).

Deloitte seeks summary judgment on Plaintiffs' Section 11 claims against it primarily on the issue of due diligence.[56] It claims that the investigation performed in connection with the March 31, 1990 Financial Statements entitles it to the "due diligence" defense. *See id.;* 15 U.S.C. § 77k(b)(3)(B). Plaintiffs respond that Deloitte cannot establish a due diligence defense because there is substantial evidence that Deloitte failed to perform a reasonable investigation into (1) Toolworks' Nintendo business, (2) Toolworks' Mindscape business, and (3) recognition of revenues on Toolworks' OEM software licensing business.[57]

Section 11 requires a "reasonable" investigation by accountants. 15 U.S.C. § 77k(b)(3). This means that accountants are expected to investigate, to various degrees, facts supporting and contradicting inclusions in registration statements. They must undertake that investigation which a reasonably prudent man in that position would conduct. *See Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *see also Escott v. Barchris Construction Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968) (accountants held to standards of their own profession, GAAS). If accountants establish a reasonable investigation

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[56]Deloitte also seeks summary judgement on grounds of lack of materiality on certain issues. Deloitte's materiality arguments will be addressed where appropriate.

[57]This Court has found that there is no evidence of scienter on the record to support Plaintiffs' Section 10(b) claims with respect to Toolworks' Nintendo business, Toolworks' Mindscape business, and recognition of revenues on Toolworks' OEM software licensing business. Section 11 liability, however, does not require proof of scienter; liability "may lie for wholly negligent conduct." *Straus v. Holiday Inns, Inc.*, 460 F. Supp. 729, 732 (S.D.N.Y. 1978).

under the circumstances of the case, they are entitled to the statutory due diligence defense.

1. Nintendo Business

The Court has found that Plaintiffs have failed to offer any admissible evidence of a material misrepresentation or omission in the March 31, 1990 Financial Statements with respect to Toolworks' Nintendo business.[58] Plaintiffs accordingly fail to establish their burden under *Celotex* for a Section 11 claim.

2. Mindscape Software

Plaintiffs allege two general misrepresentations in the March 31, 1990 Financial Statements with respect to Mindscape Software: (1) the improper inclusion of Mindscape royalty advances and guarantees in revenues; and (2) the improper inclusion of obsolete Mindscape computer software in inventory, resulting in an inventory reserve which should have been higher than stated. The Court has found that Plaintiffs have failed to offer any admissible evidence of a material overstatement with respect to royalty advances and guarantees,[59] and accordingly now finds that Plaintiffs also fail to establish their Celotex burden here.

Plaintiffs' inventory claim also suffers from the same infirmity. Plaintiffs contend that Deloitte's decision to report a 44% reserve was improper, without putting forth any evidence that a 44% reserve resulted in a material overstatement of Mindscape inventory. Plaintiffs cannot defeat sum-

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[58] *See supra* Plaintiffs vs. Deloitte, Section I.A.1.a.1. The Court further found that with respect to Plaintiff's claim regarding sales to three Nintendo distributors, Plaintiffs offer no evidence to establish that the sales took place in fiscal 1990 or are reflected in Toolworks' audited March 31, 1990 Financial Statements. *See id.* at Section I.A.1.a.1.b.

[59] *See supra* Plaintiffs vs. Deloitte, Section I.A.1.a.3.

mary judgment without producing "specific facts" to establish an essential element of their claim. *Celotex*, 477 U.S. at 322.

3. OEM Revenue Recognition

The Court has found that Deloitte performed a scienter-free audit with regards to Toolworks' OEM revenue recognition.[60] This alone does not, however, establish a Section 11 due diligence defense. Whether an auditor performed a reasonable investigation is inextricably tied to compliance with its professional standards, including GAAS and generally accepted accounting principles ("GAAP"). *See Escott v. Barchris Construction Corp.*, 283 F. Supp. at 703. Failure to comply with GAAS, GAAP and ordinary care, even where an otherwise scienter-free audit was performed, may result in Section 11 liability. *See Straus v. Holiday Inns, Inc.*, 460 F. Supp. 729, 732 (S.D.N.Y. 1978) (Section 11 liability "may lie for wholly negligent conduct."). Deloitte must establish that it performed a reasonable investigation under the circumstances in order to receive summary judgment on the Section 11 OEM revenue recognition claim.

In order for the Court to find due diligence as a matter of law, there must be no genuine issues of material historical fact in dispute. After a careful review of the record, the Court finds that there are genuine issues of material historical fact with regards to Deloitte's OEM revenue recognition due diligence. The record, for example, is replete with disputed facts regarding whether GAAS and GAAP procedures were followed by Deloitte in its OEM revenue recognition audit. Such genuine issues of material historical fact preclude summary judgment.[61]

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[60] *See id.* at Section I.A.1.a.4.

[61] By contrast, summary judgment is appropriate for the Underwriters since there are no genuine issues of material historical fact with regard

Summary judgment is therefore GRANTED in favor of Deloitte as to Plaintiffs' Section 11 claims regarding Toolworks' Nintendo business and Mindscape Software, and DENIED as to Plaintiffs' Section 11 claims regarding Toolworks' OEM revenue recognition.

II. PLAINTIFFS' MOTION FOR PARTIAL SUMMARY JUDGMENT

Plaintiffs move for summary judgment as to Section 11 and 10(b) liability on three issues: (1) the alleged misrepresentations concerning OEM revenue in the March 31, 1990 Financial Statements, (2) Deloitte's alleged failure to perform standard audit procedures with respect to the OEM and Nintendo businesses, and (3) Deloitte's alleged active participation in making fraudulent misrepresentations to the SEC concerning OEM licensing recognition revenue.

After this Court's rulings on Deloitte's motion for summary judgment, the only undecided claims in Plaintiffs' motion are Plaintiffs' Section 11 claims with respect to Toolworks' OEM revenue recognition. As set above, however, these claims are unsuited for summary judgment since they contain genuine issues of material fact.

Plaintiffs' motion for partial summary judgment is therefore DENIED.

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to the due diligence they performed; instead, the disagreement there is as to whether the due diligence performed entitles the Underwriters to a statutory defense as a matter of law. *See* Plaintiffs v. Underwriters, Section I.A.1. It is not the merits of the defense that separate the Underwriters from Deloitte; rather, it is the fact/law distinction.

CONCLUSION

For the foregoing reasons, the Court hereby rules as follows:

1. Underwriters' motion for summary judgment on all claims against them is hereby GRANTED;

2. Plaintiffs' motion for partial summary judgment against the Underwriters as to liability on Plaintiffs' Section 11 and 12(2) claims is hereby DENIED;

3. Deloitte's motion for summary judgment on all claims against them is hereby DENIED. Deloitte's motion for partial summary judgment as to Section 11 and 10(b) claims against it is hereby GRANTED IN PART AND DENIED IN PART as follows:

   a. Deloitte's motion for partial summary judgment on Plaintiffs' Section 10(b) primary liability claims is hereby GRANTED;

   b. Deloitte's motion for partial summary judgment on Plaintiffs' Section 10(b) aiding and abetting claim is hereby GRANTED;

   c. Deloitte's motion for partial summary judgment on Plaintiffs' Section 10(b) conspiracy claim is hereby GRANTED;

   d. Deloitte's motion for partial summary judgment on Plaintiffs' Section 11 claims is hereby GRANTED as to Toolworks' Nintendo business and Mindscape Software claims and DENIED as to Toolworks' OEM revenue recognition claim;

4. Plaintiffs' motion for partial summary judgment against Deloitte as to liability on Plaintiff's Section 11 and 10(b) claims is hereby DENIED.

SO ORDERED.

Dated: March 30, 1992

APPENDIX C

STATUTORY PROVISIONS

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1988), provides in relevant part:

Section 11. Civil Liabilities on Account of False Registration

a. In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions), or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

b. Notwithstanding the provisions of subsection (a), no person other than the issuer shall be liable as provided therein who shall sustain the burden of proof —

(1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement; or

(2) that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1), and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge; or

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be

made on the authority of a public official document or statement, he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and (B) as regards any part of the registration statement purporting to be made upon his authority as an expert or purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an expert; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the

time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

c. In determining, for the purpose of paragraph (3) of subsection (b) of this section what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

Section 12 of the Securities Act of 1933, 15 U.S.C. § 77l (1988), provides:

Section 12. Civil Liabilities Arising in Connection With Prospectuses and Communications

Any person who —

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of

competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1988), provides in relevant part:

Section 10. Regulation of the Use of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5, provides:

10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange —

i) to employ any device, scheme or artifice to defraud,

ii) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

iii) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

(2)

No. 94-2027

Supreme Court, U.S.
FILED
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In The

Supreme Court of the United States

October Term, 1995

MONTGOMERY SECURITIES and PAINEWEBBER INC.,

Petitioners,

vs.

RICHARD B. DANNENBERG, MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, TRUSTEES OF WILLIAM J. BING AND ARLENE S. BING LIVING TRUST, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, AND JACK SCHNITZER, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. In a case where the evidence was held sufficient to establish *deliberate concealment* of the truth, should this Court opine on the abstract question whether recklessness also would be sufficient to satisfy the scienter requirement of Section 10(b) of the Securities Exchange Act of 1934, and, if so, whether it is necessary to distinguish between "objective" and "subjective" recklessness?

2. When information is expressly "required to be stated" within the meaning of Section 11 of the Securities Act of 1933, and its omission causes a prospectus and registration statement to be misleading, can the information be withheld because its omission does not make any particular representation, viewed in isolation, misleading?

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No. 94-2027

In The

Supreme Court of the United States

October Term, 1995

MONTGOMERY SECURITIES and PAINEWEBBER INC.,

Petitioners,

vs.

RICHARD B. DANNENBERG, MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, TRUSTEES OF WILLIAM J. BING AND ARLENE S. BING LIVING TRUST, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, AND JACK SCHNITZER, On Behalf of Themselves and All Others Similarly Situated,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I. STATEMENT OF THE CASE

This case arises out of a fraudulent offering of stock in violation of provisions of the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act").

On July 10, 1990, Software Toolworks, Inc. ("Toolworks" or the "Company") sold common stock through a

public offering registered with the Securities and Exchange Commission ("SEC") on Form S-1. Petitioners in this Court, Montgomery Securities and PaineWebber, Inc., were the underwriters for the offering ("Underwriters"). The firm of Deloitte & Touche ("Deloitte") acted as Toolworks' independent accountants.

To market the offering, Toolworks and its officers misled investors and the SEC by falsifying the Company's financial results and omitting crucial information from the prospectus and registration statement for the offering. The offering was successfully marketed to investors by creating expectations of strong financial performance in fiscal 1991 (beginning April 1, 1990). The offering was initially planned to close late in the first quarter of fiscal 1991, ending June 30, 1990, and optimism about the "June quarter" was of critical importance to investors.

However, the offering was delayed and Toolworks concluded the quarter before the registration statement became effective. On July 3, 1990, the SEC, which was reviewing the registration statement, told Toolworks that it should disclose "preliminary results" for the June quarter in the prospectus. (A22). Although such results were both available and unfavorable, Toolworks, the Underwriters and Deloitte jointly drafted a July 4, 1990 letter to the SEC falsely representing that such data was *not* available but that Toolworks anticipated revenue for the quarter of between $21 and $22 million – which was also false. (A14-A18, A21-A22). In fact, the Company had booked phony sales in order to make the June quarter appear profitable.

As a consequence of these false representations, the SEC allowed the offering to proceed with no reference to the recently completed June quarter. The Company's registration statement became effective and Toolworks successfully sold more than $71 million of common stock. (A2). A few months later, when the truth caught up with Toolworks, the Company's stock dropped from its offering price of $18.50 to just $2.375. (A2).

This action ensued with the filing of a Complaint under §11 and §12(2) of the Securities Act of 1933, and §10(b) of the Exchange Act. The defendants included Toolworks, certain of its officers and directors, as well as Deloitte and the Underwriters. Toolworks and its officers quickly settled with plaintiffs for $26.5 million. (A3).

Thereafter, the district court granted summary judgment to the Underwriters and Deloitte in this case on virtually all of plaintiffs' claims. The district court held that the Underwriters met their affirmative "due diligence" defense under §11 and §12(2) as a matter of law, (A27-A36), and therefore plaintiffs also could not establish scienter for their claims under §10(b). (A36-A42). The district court similarly granted summary judgment to Deloitte on most of plaintiffs' case. (A43-A66). Plaintiffs perfected an appeal after obtaining a Rule 54(b) certification.[1]

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[1] While this case was pending on appeal in the Ninth Circuit, the SEC successfully pursued an enforcement action against Toolworks and certain of its officers based on "substantially the same facts and questions of law" as this case. *SEC v. Software Toolworks, Inc., et al.*, Civ. No. 93-3581(FMS) (N.D. Cal.) ("SEC Enforcement Action") Notice of Related Case at 1 (Sept.

Before the district court and the Ninth Circuit, the Underwriters argued that they had acted with due diligence as a matter of law, and that no reasonable jury could infer that they had acted with scienter. They did not raise any of the arguments presented now in their Petition for Writ of Certiorari. For example, nothing in the Underwriters' arguments in the lower courts suggested that liability under §10(b) may not be grounded on reckless indifference to the truth, much less that there is any distinction between "objective" and "subjective" recklessness. Nowhere did the Underwriters argue that §11 and §12(2) are designed to permit the issuance of a misleading prospectus and registration statement so long as no particular statement therein is false when considered in isolation.

The Ninth Circuit reversed in part and affirmed in part. With respect to the §11 and §12(2) claims, it held

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30, 1993). According to the SEC, Toolworks committed fraud in its registration statement on Form S-1 for the July 1990 offering as part of "a scheme to conceal, among other things, the company's drastically deteriorating sales during mid-1990," and "the effect that the deterioration was having on the company's income." SEC Enforcement Action, Complaint ¶16 (Sept. 29, 1993). The district court found that the SEC Enforcement Action was a "related case," and entered final judgments in the SEC Enforcement Action enjoining further fraudulent activity, ordering individual defendants to disgorge over $2.5 million, and barring Toolworks' Chief Financial Officer from ever again acting as an officer or director of any publicly traded company subject to registration and reporting requirements of the federal securities laws. SEC Enforcement Action, orders dated October 13, 1993.

that the Underwriters carried their burden of demonstrating "due diligence" as a matter of law with respect to certain alleged defects in the prospectus and registration statement, but not as to others. (A4-A13). Similarly, it held that while plaintiffs failed to demonstrate scienter with respect to some allegations, they succeeded as to others. Most significantly, the Court of Appeals held that the evidence was sufficient to show that the Underwriters and Deloitte *deliberately falsified and concealed the truth* with respect to the poor results for the June quarter. (A15-A18, A21-A23).

Thus, the Underwriters' "Statement of the Case" misrepresents the record in several respects. According to the Underwriters, "[t]he Ninth Circuit affirmed the district court's conclusion that the Underwriters had properly investigated all matters discussed in the prospectus." Petition for Writ of Certiorari ("Pet.") at 4. In fact, the Ninth Circuit held that the prospectus and registration statement were incomplete and could be deemed misleading for failure to discuss material data known to the defendants about the results for the June quarter:

> The Underwriters' contention that the events of this period are inapplicable to sections 11 and 12(2) liability is clearly incorrect. *Both statutory provisions require disclosure of information needed in order to make a prospectus truthful and not misleading.*

(A13 n.2) (emphasis added).

The Underwriters also represent that "[t]he Ninth Circuit did not identify any evidence that would have given the Underwriters reason to suspect that preliminary numbers [for the June quarter] were available, when

Toolworks and its counsel said [to the SEC] that they were not." Pet. at 4. This is flatly wrong. Evidence showed that Toolworks "had acknowledged to the professionals participating in the offering that some financial data for the quarter actually was available." (A22). The Ninth Circuit held that on the evidence presented, "[a] reasonable factfinder could infer that, as members of the drafting group, *the Underwriters had access to all information that was available and deliberately chose to conceal the truth.*" (A15) (emphasis added).[2]

Far from innocently relying on them, the Underwriters themselves actually helped to draft the Company's misrepresentations to the SEC – as the Ninth Circuit's opinion explains:

> The Underwriters claim that they were not involved in drafting the July 4 SEC letter and that, as a result, they have no responsibility for its contents. *The plaintiffs presented evidence, however, that the letter was a joint effort of all professionals working on the offering, including the Underwriters.* In fact, a Riordan & McKinzie partner specifically testified that, "[w]hen the

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[2] Record evidence showed that the Underwriters participated in a conference call regarding the SEC's comments in which they were told that preliminary results for the quarter were available, and in which they helped "outline[ ] what our response would be." Ninth Circuit Excerpts of Record ("ER") 317/Sylvester deposition:16-19; ER 316/277, 2013. After a draft response was prepared reflecting what Toolworks had told the entire working group – that preliminary data for the quarter *was* available – the letter was revised to falsely represent that such data was *not* available, but nonetheless to confirm expectations of $21 million in revenues and $3 to $4 million in profits for the quarter. *Compare* ER 289/285 *with* 316/2006.

> letter finally went to the SEC, all parties had been involved in the process of creating it. There had been conference calls discussing it and comments and changes made by a lot of different members of the working group." [ER 317/Weeks:40-41]. *Others similarly testified that the Underwriters were actively involved in discussions of how to respond to the SEC's inquiries regarding the June quarter.* [*See* ER 317/Barker:23-24; ER 317/Sylvester: 18-19].

(A15) (emphasis added).

Finally, the Underwriters assert that "the Underwriters' actual mental state was irrelevant to the court's analysis." Pet. at 5. That is not true. Again, the court held that a reasonable trier of fact could conclude that the Underwriters *"deliberately chose to conceal the truth."* (A15, A18) (emphasis added).

II. SUMMARY OF ARGUMENT

The "Questions Presented" by the Underwriters were neither raised nor decided below. Generally speaking, an issue should be presented to a court of appeal before it is presented on petition for certiorari. However, even if this defect could be overlooked, the case is not an appropriate one for this Court's review. The questions themselves are not presented on the factual record in this case, and are insubstantial in any event.

The Underwriters say that this case presents the question whether recklessness can suffice to establish scienter under §10(b). This question is not properly presented. The Ninth Circuit held that on the record in this case, "[a] reasonable factfinder could infer that . . . the

Underwriters had access to all information that was available *and deliberately chose to conceal the truth.*" (A15, A18) (emphasis added).

The Underwriters' assertion that lower courts are in "disarray" regarding the scienter standard for §10(b) actions is nonsense. The lower courts uniformly hold that recklessness suffices to establish scienter under §10(b), and far from disagreeing about what constitutes reckless conduct, the lower courts uniformly apply the so-called "*Sundstrand*-standard" articulated in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

Moreover, Congress is currently considering legislation addressing the scienter standard for §10(b) actions. H.R. 1058 passed the House of Representatives on March 8, 1995, and S.240 passed the Senate on June 28, 1995. For this Court to grant certiorari to determine whether recklessness satisfies the scienter requirement of §10(b), or to determine what the correct recklessness standard should be, even if it were otherwise appropriate, makes no sense with legislation pending.

In short, there is no conflict among the circuits, no substantial disagreement regarding the controlling legal standard for recklessness, and no reason for this Court to intervene in order to make new law.

The Underwriters' contentions regarding liability under §11 of the Securities Act are equally insubstantial. Section 11 imposes liability if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact *or omitted to state a material fact required to be stated therein* or necessary to

make the statements therein not misleading . . . . " 15 U.S.C. §77k(a) (emphasis added). Information regarding the completed quarter that ended June 1990 was "required to be stated" within the meaning of §11, but was omitted from the prospectus and registration statement. The information was required by Item 303 of Regulation S-K. 17 C.F.R. §229.303. The SEC told Toolworks and the Underwriters that the information should be included in the prospectus and registration statement. (A22). The Underwriters' own experts testified that disclosure of this data was required. (A13 n.2).

The Underwriters' argument that the information was not required to be included in the prospectus is based on a misquotation of §11 that omits the operative statutory language, a real or feigned ignorance of the specific requirements of SEC regulations governing registration statements, and a gross mischaracterization of the Ninth Circuit's opinion. The Underwriters' assertion that §11 permits misleading prospectuses so long as no particular statement in the prospectus, taken in isolation, is literally false, is simply ludicrous.

Whether the Underwriters acted with scienter, and whether the prospectus and registration statement were misleading are, in any event, questions of fact. If it is necessary for this case to occupy this Court's time, it can be dealt with at a later stage in this litigation – on a full record after a trier of fact has rendered a verdict. There is no reason for the Court to intervene at this preliminary stage.

III. ARGUMENT

A. Because The Evidence Presented Is Sufficient To Support An Inference Of Deliberate Concealment, The Underwriters' Arguments Regarding Whether Recklessness Might Also Suffice Are Not Properly Presented

The Underwriters' first Question Presented asks "[i]s recklessness sufficient to satisfy the scienter requirement of Section 10(b) of the Securities Exchange Act of 1934, and if so, is it necessary to show at least subjective (*i.e.*, conscious) recklessness?" But the Ninth Circuit's decision regarding the Underwriters does not turn on recklessness at all. Given the evidence presented by plaintiffs, the Ninth Circuit held: "A reasonable factfinder could infer that . . . the Underwriters . . . *deliberately chose to conceal the truth.*" (A15, *see also* A18, A22) (emphasis added). That is far more than recklessness.

Because deliberate fraud satisfies §10(b)'s scienter requirement without resort to concepts of recklessness, the Underwriters' first "Question Presented" is not presented at all. Moreover, because deliberate fraud involves subjectively "conscious" conduct, none of the Underwriters' arguments regarding purported distinctions between "objective recklessness" and "subjective recklessness" can have any significance on the record in this case.

B. Even If The Question Were Properly Presented, It Is Well-Settled That Reckless Conduct Is "Intentional" Or "Knowing" For Purposes Of Section 10(b)'s Scienter Element

The question whether reckless disregard suffices to establish scienter should not consume this Court's time in any event.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) this Court recognized that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct," indicating, without deciding, that it could satisfy the scienter requirement of §10(b). *Id.* at 193 n.12. The Court stated that §10(b) proscribes "knowing or intentional misconduct," *id.* at 193 n.12, 197, but cautioned that recklessness might be considered "a form of intentional conduct" for these purposes. *Id.* at 193 n.12. Every court to consider the issue has concluded that reckless conduct does suffice to establish scienter.[3]

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[3] *See, e.g., Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 46 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 960-61 (5th Cir.) (en banc), *cert. denied*, 454 U.S. 965 (1981); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1024 (6th Cir. 1979); *Sundstrand*, 553 F.2d at 1044; *Stokes v. Lokken*, 644 F.2d 779, 783 (8th Cir. 1981); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Woods v. Barnett Bank of Fort Lauderdale*, 765 F.2d 1004, 1010 (11th Cir. 1985); *SEC v. Steadman*, 967 F.2d 636, 641-42 (D.C. Cir. 1991).

The Underwriters argue that the circuit courts are all wrong because *Ernst & Ernst* requires "knowing or intentional misconduct." But a statement made with reckless disregard for its truth *is a knowing falsehood*. In *Cooper v. Schlesinger*, 111 U.S. 148, 155 (1884), this Court held that "the jury were properly instructed that *a statement recklessly made*, without knowledge of its truth, *was a false statement knowingly made*."[4] This was hornbook law when Congress enacted the federal securities acts, just as it is hornbook law today.[5] As a matter of law, "reckless

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[4] *Id.* at 155 (emphasis added). In *Lehigh Zinc & Iron Co. v. Bamford*, 150 U.S. 665 (1893), this Court held that "a person who makes representations of material facts, assuming or intending to convey the impression that he has actual knowledge of the existence of such facts, when he is conscious that he has no such knowledge, is as much responsible for the injurious consequences of such representations, to one who believes and acts upon them, as if he had actual knowledge of their falsity . . . . " *Id.* at 673. Nearly a century later, in *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 2758 (1991), this Court held in a case arising under §14(a) of the Exchange Act that public representations "in a commercial context are reasonably understood to rest on a factual basis that justifies them as accurate, the absence of which renders them misleading." Thus, a statement made with knowledge that it lacks a reasonable basis is a statement made with knowledge of its misleading character – that is, *with intent to mislead* or defraud. *See Lehigh Zinc*, 150 U.S. at 673; *Cooper*, 111 U.S. at 155.

[5] The leading hornbook on the law of fraud before the enactment of the federal securities statutes explained: "[I]f a man makes a positive representation of fact, believing it to be true, without having any information or any adequate information upon which to base it . . . *he then acts, to his own knowledge, falsely* . . . . " Melville M. Bigelow, *The Law of Fraud* §3, at 62-63

conduct is viewed as a form of knowing conduct," and making statements with a reckless indifference to their truth or falsity is just one variety of intentional or knowing falsehood. *Rolf*, 570 F.2d at 45.

The Underwriters further contend that all the circuits are wrong because §10(b) liability should be imposed only where defendants lack an honest belief in the truth and completeness of what they said. But a reckless statement is not a statement *honestly* made:

> "[A] representation recklessly made, without knowledge of its truth, cannot be a statement honestly believed, but, on the contrary, is regarded as a false statement knowingly made. . . . [I]n putting his statement in such form as to amount to an assertion that he has knowledge of its truth, [one] is guilty of an intentional falsehood."

(1877) (emphasis added). Today's leading hornbook on the law of torts restates the principle:

> There is of course no difficulty in finding the required *intent to mislead* where it appears that the speaker believes his statement to be false. Likewise, there is general agreement that *it is present when the representation is made without any belief as to its truth, or with reckless disregard whether it be true or false.* Further than this, it appears that all courts have extended it to include representations made by one who is conscious that he has no sufficient basis for information to justify them.

W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, *Prosser and Keeton on the Law of Torts* §107, at 741-42 (5th ed. 1984) (emphasis added, footnotes omitted).

Otis & Co. v. Grimes, 97 Colo. 219, 222, 48 P.2d 788, 789 (1935) (citation omitted); *see also Kriner v. Dinger*, 297 Pa. 576, 582, 147 A. 830, 832 (1929).

"Fraud," wrote Justice Cardozo, "includes the pretense of knowledge when knowledge there is none." *Ultramares Corp. v. Touche*, 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931). Even the old English decisions on which the Underwriters rely recognized this: "For a man who makes a statement without care and regard for its truth or falsity commits a fraud. He is a rogue."[6]

In short, there is no conflict among the circuits, and no reason to think the circuit courts are wrong. As noted above, Congress appears to be in the process of codifying standards for §10(b) liability in any event. *See* H.R. 1058 (*passed* March 8, 1995); S.240 (*passed* June 28, 1995).

C. There Is No Conflict Among The Circuits Regarding The Showing Required To Establish Recklessness Under Section 10(b)

The Underwriters argue that the lower courts are "in disarray" about the standard for determining whether conduct is reckless under §10(b). They are wrong.

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[6] *Derry v. Peek*, 14 App. Cas. 337, 350 (H.L. 1889) (Lord Bramwell). They held that reckless misrepresentations are by no means "innocent" misrepresentations. *See Arkwright v. Newbold*, 17 Ch. D. 301, 320 (1881) (Cotton, L.J.) ("in an action of deceit the representation to found the action *must not be innocent*, that is to say, it must be made either with knowledge of its being false, *or with a reckless disregard* as to whether it is or is not true") (emphasis added).

One circuit after another has adopted the so-called "*Sundstrand* standard," first articulated in *Franke v. Midwestern Oklahoma Development Authority*,[7] and adopted by the Seventh Circuit in *Sundstrand*, 553 F.2d at 1044-45. Under *Sundstrand*:

> " '[R]eckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.' "

Id. at 1045 (citation omitted).

Sundstrand's formulation has become a uniform national standard, explicitly adopted and applied by the First,[8] Second,[9] Third,[10] Fifth,[11] Sixth,[12] Seventh,[13]

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[7] 428 F. Supp. 719, 725 (W.D. Okla. 1976), *vacated on other grounds*, 619 F.2d 856 (10th Cir. 1980).

[8] *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978).

[9] *Rolf*, 570 F.2d at 47.

[10] *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *McLean*, 599 F.2d at 1197-98.

[11] *Broad*, 642 F.2d at 960-61; *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994).

[12] *Ohio Drill & Tool Co. v. Johnson*, 625 F.2d 738, 741 (6th Cir. 1980).

[13] *Sundstrand*, 553 F.2d at 1044-45.

Eighth,[14] Ninth,[15] Tenth,[16] Eleventh,[17] and District of Columbia[18] Circuits – as well as by district courts in the Fourth Circuit.[19] No circuit court has rejected the *Sundstrand* standard.

Nonetheless, the Underwriters try to manufacture a conflict among the circuits by contending that some courts require "subjective" recklessness, while others require "objective" recklessness. Such distinctions are products of the Underwriters' imagination, and can have no relevance in this case, for the Ninth Circuit again held that on the evidence presented "[a] reasonable factfinder could infer that . . . the Underwriters . . . *deliberately chose to conceal the truth.*" (A15). There is nothing ambiguous about the Ninth Circuit's focus on the *subjective* and *deliberate* intent of the Underwriters. Thus, the Underwriters' contentions that the Ninth Circuit's decision turned on some hypothetical distinction between "objective recklessness" and "subjective recklessness" is patent nonsense. Moreover, any distinction between "objective" and "subjective" recklessness is inconsequential at the summary judgment stage. For if the evidence sufficiently

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[14] *K&S Partnership v. Continental Bank, N.A.*, 952 F.2d 971, 978 (8th Cir. 1991), *cert. denied*, ___ U.S. ___, 112 S. Ct. 2993 (1992).

[15] *Hollinger*, 914 F.2d at 1569-70.

[16] *Hackbart*, 675 F.2d at 1118.

[17] *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1324 (11th Cir. 1982).

[18] *SEC v. Steadman*, 967 F.2d at 641-42.

[19] *PPM America, Inc. v. Marriott Corp.*, 875 F. Supp. 289, 301-02 (D. Md. 1995); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730, 740 (W.D. Va. 1982).

demonstrates that the Underwriters were "objectively" reckless, how can they argue that a jury may not determine that they were in fact "subjectively" reckless?

The Underwriters contend that the Ninth Circuit follows an "objective recklessness" standard that allows liability to be grounded on mere negligence. But sitting en banc in *Hollinger*, 914 F.2d at 1569, the Ninth Circuit expressly rejected negligence as a basis of liability under §10(b), holding that to satisfy *Sundstrand's* recklessness standard a defendant's conduct " 'must derive from something more egregious than even "white heart/empty head" good faith.' " *Hollinger*, 914 F.2d at 1569-70 (quoting *Sundstrand*, 553 F.2d at 1045). In the decision below, the Ninth Circuit again expressly held that " 'recklessness' is conduct 'involving *not merely simple or even inexcusable negligence* . . . . ' " (A17) (quoting *Hollinger*, 914 F.2d at 1569 (quoting *Sundstrand*, 553 F.2d at 1044-45)). It rejected a portion of plaintiffs' claims against Deloitte because "[a]t most, the evidence establishes that Deloitte was negligent in auditing Toolworks, not that Deloitte recklessly or knowingly falsified the financial statements." (A20).

Those who misstate or conceal the truth seldom candidly admit that they did so with scienter. As a consequence, direct evidence of intent to defraud or recklessness seldom exists, and proof of state of mind almost always requires resort to objective evidence regarding the circumstances surrounding the defendant's

conduct.[20] In *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 n.30 (1983), this Court recognized that "the proof of scienter required in fraud cases is often a matter of inference from circumstantial evidence," as it warned against adopting a high standard of proof for scienter in securities fraud cases. The fact that scienter may be inferred from objective circumstances cannot be transformed into any "conflict" between "objective recklessness" and "subjective recklessness" that requires review by this Court.

D. The Petition Presents No Substantial Question Regarding The Scope Of Liability Under Sections 11 and 12

The Underwriters' second "Question Presented" to the Court is:

> Under Section 11 and Section 12(2) of the Securities Act of 1933, does the fact that information is "material" create an affirmative duty of disclosure, even though the information does not render misleading any statement in the prospectus or registration statement?

This question is not presented at all. Section 11 imposes liability if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact *or omitted to state a material fact required to be stated therein* or necessary to

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[20] *See In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1241 (3d Cir. 1989); *United States v. Cohen*, 516 F.2d 1358, 1367 (8th Cir. 1975); *United States v. Sullivan*, 406 F.2d 180, 186 (2d Cir. 1969); *Benchwick v. United States*, 297 F.2d 330, 333 n.5 (9th Cir. 1961).

make the statements therein not misleading . . . . " 15 U.S.C. §77k(a) (emphasis added). The omitted information in this case was *required to be stated* within the meaning of §11.[21]

The omitted information was required to be disclosed by Item 303 of Regulation S-K, which requires the registrant to provide specific information regarding liquidity, capital resources, and results of operations, as well as any other information "necessary to an understanding of its financial condition, changes in financial condition and results of operations." Reg. S-K, Item 303(a), 17 C.F.R. §229.303(a). The registrant must "[i]dentify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant's liquidity increasing or decreasing in any material way." Reg. S-K, Item 303(a)(1), 17 C.F.R. §229.303(a)(1). The registrant must "[d]escribe any known material trends, favorable or unfavorable, in

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[21] The Underwriters' effort to manufacture a question for this Court actually requires them to misquote §11 itself. In their Petition for Writ of Certiorari, crucial words of the statutory text disappear in an ellipsis:

> Section 11 and Section 12(2) by their terms require the identification of a specific statement that is either untrue, or that is rendered misleading by an omitted fact. Section 11 provides that the plaintiff must prove that the registration statement "contain[s] an untrue statement of a material fact or omit[s] to state a material fact . . . necessary to make *the statements therein* not misleading."

Pet. at 24 (misquoting 15 U.S.C. §77k(a)) (emphasis added by Underwriters). This is an outrageous misquotation of the statute.

the registrant's capital resources," and "[i]ndicate any expected material changes in the mix and relative cost of such resources." Reg. S-K, Item 303(a)(2)(ii), 17 C.F.R. §229.303(a)(2)(ii). Finally, the registrant must:

> Describe any known trends or uncertainties *that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.* If the registrant knows of events that will cause a material change in the relationship between costs and revenues . . . the change in the relationship shall be disclosed.

Reg. S-K, Item 303(a)(3)(ii), 17 C.F.R. §229.303(a)(3)(ii) (emphasis added).

As a consequence, *"the SEC told Toolworks that it should disclose 'preliminary results' for the June quarter in the prospectus."* (A22) (emphasis added). Moreover, the Underwriters' own experts testified that this information was required, as the Ninth Circuit recites:

> *As the Underwriters' own experts testified,* poor first quarter earnings prior to the effective date of the offering would definitely constitute material information and *would have to be disclosed.*

(A13 n.2) (emphasis added); *see* ER 290/Isgur deposition: 270-72; ER 290/Farr deposition: 210-13.

Contending that the Ninth Circuit, the SEC and their own experts were wrong, the Underwriters now assert that the Ninth Circuit never considered whether the information was required. Pet. at 24-25 n.19. That is ludicrous. In the alternative, they contend that Item 303 of Regulation S-K does not even apply to registration statements governed by §11. Pet. at 24-25 n.19. This too is

flatly wrong. By its terms, Regulation S-K applies to "[r]egistration statements under the Securities Act . . . to the extent provided in the forms to be used for registration under such Act,"[22] and Form S-1 expressly requires the "[i]nformation required by Item 303 of Regulation S-K, management's discussion and analysis of financial condition and results of operations."[23] Toolworks filed its registration statement for the July 1990 offering on Form S-1, and thus was required to comply with Item 303.

Because the omitted information was required to be disclosed, it is not necessary to determine whether its absence also made the registration statement misleading. *See* 15 U.S.C. §77k(a). However, failure to disclose the disastrous June quarter results did make the prospectus and registration statement misleading, because it did not adequately inform investors regarding the real state of Toolworks' business. Concealing the fact that the Company's just-completed quarter was a disaster made the

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[22] Reg. S-K, Item 10, 17 C.F.R. §229.10.

[23] Form S-1, Item 11(h); *see also* Form S-2 Item 11(b)(7) ("Furnish management's discussion and analysis of the registrant's financial condition and results of operations required by Item 303 of Regulation S-K."). Even where registrants are permitted to incorporate information by reference to filings on Forms 10-K and 10-Q, which defendants concede are subject to Item 303 of Regulation S-K, the registrant must "[d]escribe any and all material changes in the registrant's affairs which have occurred since the end of the latest fiscal year for which certified financial statements were included in the latest annual report to security holders and which were not described in a Form 10-Q or quarterly report delivered with the prospectus . . . . " Form S-2, Item 11(a)(4); *see also* Form S-3, Item 11(a); Form S-4, Item 12(a)(4).

prospectus and registration statement plainly misleading. This fact was effectively conceded by the Underwriters' own witnesses, who admitted that if the truth had been told about the quarter, the offering would have been cancelled. ER 290/Isgur deposition: 270-72; *see also* ER 290/Farr deposition: 210-13; ER 341/Meyers deposition: 149-51. The Ninth Circuit thus held that Plaintiffs presented evidence sufficient for a jury to conclude that the prospectus and registration statement were misleading. (A13 n.2).

The Underwriters contend that nonetheless, no particular statement in the registration statement was literally false. The Underwriters ask this Court to assume that §11 and §12(2) implicitly draw some metaphysical distinction between a misleading registration statement and the misleading statements that together constitute the registration statement. Pet. at 24. This is ludicrous. Courts have always understood §11 to prohibit misleading registration statements. They have always held that specific statements within a registration statement must be evaluated in context to determine whether they operated together to convey a misleading impression:

> Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers.

McMahan & Co. v. Wherehouse Entertainment, 900 F.2d 576, 579 (2d Cir. 1990), *cert. denied*, 501 U.S. 1249 (1991); *see,*

e.g., Greenapple v. Detroit Edison Co., 618 F.2d 198, 205 (2d Cir. 1980); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 563-66 (E.D.N.Y. 1971).

This Court has far better things to do with its time than to consider arguments that Congress designed §11 and §12(2) to allow misleading prospectuses and registration statements, so long as care is taken to ensure that no particular sentence therein is literally false when considered in isolation.

IV. CONCLUSION

For the foregoing reasons, the petition for writ of certiorari should be denied.

DATED: July 12, 1995

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(3)

No. 94-2027

In The Supreme Court

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OCTOBER TERM 1994

MONTGOMERY SECURITIES and PAINEWEBBER INC.,
Petitioners,
vs.
RICHARD B. DANNENBERG, *et. al.,* On Behalf of Themselves and all others Similarly Situated.
Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMERICAN BANKERS ASSOCIATION, THE AMERICAN ELECTRONICS ASSOCIATION, THE ASSOCIATION OF PUBLICLY TRADED COMPANIES, THE NATIONAL ASSOCIATION OF MANUFACTURERS, AND THE SECURITIES INDUSTRY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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Pursuant to Rule 37.2 of the Rules of this Court, *amici,* the American Bankers Association ("ABA"), the American Electronics Association ("AEA"), the Association of Publicly Traded Companies ("APTC"), the National Association of Manufacturers ("NAM"), and the Securities Industry Association ("SIA"), respectfully move for leave

to file the attached Brief of *Amici Curiae* in Support of the Petition for Writ of Certiorari. Petitioners Montgomery Securities and PaineWebber Incorporated have consented to the filing of the brief. This motion is necessary because Respondents have denied consent.

The *amici,* non-profit trade associations, share a concern regarding the burdens imposed by vexatious litigation brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5. 17 C.F.R. § 240.10b-5. *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 739 (1975); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S. Ct. 1439, 1454 (1994). *Amici* have a substantial interest in limiting abusive litigation under the federal securities laws and in clarifying the standard of liability under Section 10(b), the most frequently invoked civil liability provision of the Exchange Act.

The ABA, a not-for-profit corporation, is the largest national trade association of the commercial banking industry in the United States. Member banks of the ABA are located in each of the fifty states and the District of Columbia. ABA members have been and are currently subject to claims under Section 10(b) implicating the questions presented in the petition for *certiorari.*

The AEA represents approximately 3,000 companies in 44 states, spanning the breadth of the electronics industry, including the semiconductor, software, computer, telecommunications, networks, and systems fields. Members of the AEA have been and are currently subject to claims raising the questions presented in the petition.

APTC's membership of more than 500 corporations includes the newest and smallest publicly traded firms as well as larger, more mature corporations. APTC represents its members' interests without regard to industry affiliation or

geographic location, and concentrates on issues of concern to publicly traded corporations. APTC members have been targets of Section 10(b) private securities fraud litigation. APTC members recognize from experience that the burdens imposed by vexatious securities fraud litigation can raise the cost of capital and divert resources from productive activity to nonproductive litigation-related matters.

The NAM is the nation's oldest and largest broad-based industrial trade association. Its more than 13,500 member companies and subsidiaries, including 10,000 small manufacturers, employ approximately eighty-five percent of all manufacturing workers and produce over eighty percent of the nation's manufactured goods. More than 158,000 additional businesses are affiliated with the NAM through its Associations Council and National Industrial Council. The NAM has a vital interest in the reasonable enforcement of the securities laws. The NAM believes spurious securities litigation has the potential to impact the competitiveness and profitability of all publicly traded businesses.

The SIA is the principal trade association of the securities industry. Its members include more than 700 broker-dealers and investment banking firms in the United States and Canada. When members of the SIA underwrite public offerings of securities that become the subject of class action lawsuits alleging claims under Section 10(b), they are often included among the parties named as defendants. Even when such litigation is ultimately found to be without merit, the litigation is expensive to defend and can injure defendants' reputation.

Amici submit that the decision of the court of appeals in this case raises a significant and recurring issue regarding the required mental state for violations of Section 10(b) and Rule 10b-5, and will subject defendants to unwarranted liability for innocent behavior. Many members of *amici* trade associations are located within the jurisdiction of the

Ninth Circuit and stand to be particularly affected by the decision below.

The issues presented by this case are of exceptional importance to *amici* and to their members. *Amici* seek to promote a consistent interpretation of the federal securities laws that retains fidelity to the statutory language and legislative history. *Amici* therefore respectfully seek leave of this Court to file the attached brief in support of the petition for writ of certiorari.

Respectfully submitted,

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QUESTIONS PRESENTED

1. "[W]hether, in some circumstances, reckless behavior is sufficient for civil liability under" Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976) (reserving this question); *see also Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) (same).

2. If reckless behavior can, in some circumstances, suffice for implied civil liability under Section 10(b) and Rule 10b-5, what definition of "recklessness" establishes such liability?

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INTERESTS OF *AMICI CURIAE*

This brief *amici curiae*, accompanied by motion for leave to file under Rule 37.2, is presented by the American Bankers Association, the American Electronics Association, the Association of Publicly Traded Companies, the National Association of Manufacturers, and the Securities Industry Association in support of the petition of Montgomery Securities and PaineWebber Incorporated for a writ of *certiorari* to review the decision of the United States Court of Appeals for the Ninth Circuit in this case.

As detailed in the motion accompanying this brief, this case is of great significance to the trade associations appearing as *amici*, as well as to their individual members. Members of *amici* trade associations have been subject to lawsuits that raise the specific questions presented for review in this case. Moreover, petitioners in this case are both members of *amicus* Securities Industry Association. A substantial volume of litigation raising the questions presented in this petition has arisen and will continue to arise in the Ninth Circuit.

REASONS FOR GRANTING THE WRIT

The Petition for a Writ of Certiorari should be granted for three distinct reasons.

This Court has twice reserved the question of whether recklessness constitutes a state of mind sufficient to impose liability under the Section 10(b) implied private right of action. 15 U.S.C. § 78j(b). Neither the text, nor the structure, nor the legislative history of the statute support such liability. The petition should be granted so that this Court can correct the error below and establish that recklessness is not sufficient to establish liability under the implied Section 10(b) private right of action. The error below is not

unique and arises in a large number of cases across all Circuits.

Second, the Circuits are split over the definition of recklessness that supports implied private Section 10(b) liability and the Securities and Exchange Commission advocates a definition inconsistent with the approach adopted by the majority of Circuits. Confusing definitions and contradictory results abound. The petition should be granted so that, if this Court holds that recklessness suffices to establish Section 10(b) liability, this Court can articulate a uniform definition of recklessness.

Third, vexatious litigation under Section 10(b) imposes substantial costs on the economy. The financial risk inherent in securities fraud litigation can also force innocent defendants to enter into expensive settlement agreements. An interpretation of Section 10(b) that retains fidelity to the statutory text by requiring a showing of scienter — and not any lesser state of mind — will preserve the Securities and Exchange Commission's enforcement authority, deter vexatious litigation, and keep open the courthouse door to private party plaintiffs harmed by the conscious frauds against which Section 10(b) was designed to protect.

ARGUMENT

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), this Court held that scienter is a necessary element of an implied private action for damages under Section 10(b) and Rule 10b-5. 17 C.F.R. § 240.10b-5. This Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 194 n.12. This Court has, however, twice reserved "the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id. See also Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) ("we have explicitly left open the

question whether recklessness satisfies the scienter requirement").

This Court's silence of nearly two decades has promoted substantial splits among the Circuits. These splits have spawned widespread confusion and fostered much litigation. More fundamentally, this Court's silence has allowed the lower courts to interpret Section 10(b) in a manner that is inconsistent with the text of the statute and that conflicts with its legislative history. The scope of liability for reckless conduct in an implied private right of action under Section 10(b) stands as a recurring and significant unanswered question in the interpretation of the federal securities laws. This petition presents a particularly felicitous opportunity to resolve that question.

I. RECKLESS BEHAVIOR IS INSUFFICIENT FOR CIVIL LIABILITY UNDER THE IMPLIED § 10(b) PRIVATE RIGHT.

Section 10(b) "does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy. . . ." *Hochfelder*, 425 U.S. at 196. While the implied private right of action under Section 10(b) is "beyond peradventure," *Huddleston*, 459 U.S. at 380, the rationale for the right's existence has never been articulated by this Court.[1]

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[1]The Supreme Court recognized the implied § 10(b) private right of action "with virtually no discussion." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). The law governing the implication of private rights has changed substantially since the § 10(b) private right was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). Every rationale relied on by the lower courts in creating the implied right has since been repudiated by this Court, and there is substantial doubt that this Court would imply a private § 10(b) right of action for money damages if the issue presented itself on a clean slate. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action*

This Court has also "made no pretense that it was Congress' design to provide the remedy afforded" by the implied Section 10(b) cause of action,[2] and there is, at most, a congressional "acknowledgment of the Rule 10b-5 action without any further expression of legislative intent to define it."[3] Indeed, this Court has recognized a sea change

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Under the Federal Securities Laws: The Commission's Authority, 107 Harv. L. Rev. 961, 986-89 (1994).

[2] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 359 (1991). Accord, Brief for the Securities and Exchange Commission as *Amicus Curiae* Supporting Respondents at 24 n.32, *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (No. 93-404), reprinted in *The SEC Speaks in 1995* at 872, 895 n.32 (Practising Law Institute 1995).

[3] *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2089 (1993). "Congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction. . . ." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1453 (1994) (quotation omitted). The Senate has recently passed legislation that prescribes a pleading standard for § 10(b) private actions but specifically avoids any definition of the element of scienter required to establish a § 10(b) violation. S. 240, 104th Cong., 1st Sess. § 104(b) (June 28, 1995) (referring generally to private actions arising under the Securities Exchange Act that require proof that "defendant acted with a particular state of mind" without defining any such state of mind). *See also* 144 Cong. Rec. S 9171 (daily ed. June 27, 1995) (remarks of Senator Specter, sponsor of the amendment adopted as § 104(b), explaining that the amendment relates solely to pleading requirements). The House of Representatives has recently passed legislation that would expand the definition of scienter to include and define recklessness. H.R. 1058, 104th Cong., 1st Sess. § 4 (1995) (Mar. 12, 1995).

The uncertain potential for Congressional action — especially when the Senate bill preserves the questions presented for review — is not an impediment to the grant of the petition. This Court has very recently granted *certiorari* in cases raising questions that could be mooted by currently pending legislation. *See United States v. Chesapeake & Potomac Tel. Co. of Va.*, (No. 94-1893) and *National Cable Television Ass'n. v. Bell Atlantic Corp.*, (No. 94-1900) (presenting question of constitutionality of cross-ownership restrictions barring local telephone

in its approach to the interpretation of the implied Section 10(b) right and has emphasized that the implied nature of the right does not provide license to abandon "adherence to the statutory language." *Central Bank*, 114 S. Ct. at 1446.[4]

A. Neither the Text Nor the Legislative History of Section 10(b) Support Liability For Reckless Behavior

"The starting point in every case involving construction of a statute is the language itself."[5] Because Congress "did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme," this Court has been forced "to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5

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companies from entering cable television business), *petitions for cert. granted*, 63 U.S.L.W. 3906 (U.S. June 27, 1995). *See also* S. 652, 104th Cong., 1st Sess. § 202 (June 15, 1995) (eliminating cable and telephone company cross-ownership restrictions). The securities bills passed by each chamber would, moreover, apply only to lawsuits filed after the legislation's effective date and would leave hundreds of pending cases alleging billions of dollars in damages to be resolved under incorrect and conflicting precedent.

[4] *See also Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102-03 (1991) (recognizing that *Cort v. Ash*, 422 U.S. 66, 78 (1975), and *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575 (1979), emphasize the importance of an inquiry into Congressional intent to authorize a private cause of action and that this emphasis on Congressional intent became clear only after the § 10(b) and § 14(a), 15 U.S.C. § 78n(a), implied private rights had been recognized by the Court).

[5] *Hochfelder*, 425 U.S. at 197 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). *See also Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1074 (1995) (Thomas, J., dissenting); *Central Bank*, 114 S. Ct. at 1446; *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977).

action been included as an express provision in the 1934 Act."[6]

The inference from the language of the statute is clear. Congress would not have created Section 10(b) liability for reckless behavior.

Section 10(b) prohibits "any manipulative or deceptive device or contrivance" in contravention of rules adopted by the Commission pursuant to Section 10(b)'s delegated authority. The terms "manipulative," "device," and "contrivance" "make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." *Hochfelder*, 425 U.S. at 199. The intent was to "proscribe *knowing* or *intentional* misconduct." *Id.* (emphasis supplied). In addition, the "use of the word "manipulative" is especially significant [because] [i]t is and was virtually a term of art when used in connection with securities markets. It connotes *intentional* or *willful* conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* (footnote omitted) (emphasis supplied).

A market cannot be manipulated in violation of the Exchange Act through inadvertence or with lack of subjective consciousness. Nor can one construct a device or contrivance absent subjective awareness. The words, "manipulative," "device," or "contrivance," by their very nature, require conscious intent and connote purposive activity.[7] The mental state consistent with the statute can be achieved

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[6] *Central Bank*, 114 S. Ct. at 1441-42 (quoting *Musick, Peeler*, 113 S. Ct. at 2089-90).

[7] *See Hochfelder*, 425 U.S. at 199 n. 20 ("device" means " 'that which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice' ") (quoting Webster's International Dictionary (2d ed. 1934)); *id.* (defining "contrivance" as " '[a] thing contrived or used in contrivance; a scheme,

only if a defendant acts with a state of mind "embracing" — an active verb — "intent" — requiring a conscious state of mind — "to deceive, manipulate or defraud."[8]

The legislative history compels the same conclusion. "[T]here is no indication that § 10(b) was intended to proscribe conduct not involving scienter." *Hochfelder*, 425 U.S. at 202; *see also Aaron v. SEC*, 446 U.S. 680, 691 (1980) (same). Indeed, "[i]n considering specific manipulative practices left to Commission regulation . . . the [Congressional] reports indicate that liability would not attach absent scienter, supporting the conclusion that Congress intended no lesser standard under § 10(b)." *Hochfelder*, 425 U.S. at 204. Congress thus "evidenced a purpose to proscribe only *knowing* and *intentional* misconduct." *Aaron*, 446 U.S. at 690 (emphasis supplied).

B. The Structure of the Statute Underscores That There Is No Section 10(b) Liability for Recklessness

In drafting the federal securities laws, Congress knew how to use specific language to impose liability for reckless or negligent behavior and how to create strict liability for violations of the federal securities laws.[9] But Congress did not use such language to impose Section 10(b) liability on

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plan, or artifice," obviate . . . design; invent . . . to scheme' " (quoting Webster's International Dictionary (2d ed. 1934)).

[8] *Hochfelder*, 425 U.S. at 193 n.12. *Cf. Santa Fe Industries*, 430 U.S. at 478; *Schreiber v. Burlington Northern Inc.*, 472 U.S. 1, 5-8 (1985).

[9] Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, for example, imposes strict liability on the issuer for material misstatements or omissions in a registration statement and a "sliding scale" negligence standard on other participants in the offering process. *See Hochfelder*, 425 U.S. at 208. Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2),(3), impose liability for negligent or reckless conduct in the sale of securities. *Aaron*, 446 U.S. at 697.

reckless behavior. Therefore, just as there is no liability for aiding and abetting a violation of Section 10(b) because Congress knew how to create such liability but did not;[10] and just as there is no liability under Section 12(1) of the Securities Act, 17 U.S.C. § 77l(1) for participants who are merely collateral to an offer or sale because Congress knew how to create such liability but did not;[11] and just as there is no remedy under Section 10(b) for those who neither purchase nor sell securities because Congress knew how to create such a remedy but did not;[12] there can be no liability for reckless conduct under Section 10(b) because Congress clearly knew how to impose liability for reckless behavior but did not.

This Court has, moreover, emphasized that the securities laws "should not be read as a series of unrelated and isolated provisions."[13] The federal securities laws are to be interpreted consistently and as part of an interrelated whole.[14] In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), the Court reserved "the question whether scienter was necessary for liability under § 14(a)."[15] The Court nonetheless held that statements of "reasons, opinions or

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[10] *Central Bank*, 114 S. Ct. at 1448 ("Congress knew how to impose aiding and abetting liability when it chose to do so.") (citing statutes).

[11] *Pinter v. Dahl*, 486 U.S. 622, 650 & n.26 (1988) (Congress knew how to provide liability for collateral participants in securities offerings when it chose to do so).

[12] *Blue Chip*, 421 U.S. at 734. ("When Congress wished to provide a remedy for those who neither purchase nor sell securities, it had little trouble doing so expressly.") .

[13] *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1067 (1995).

[14] *See, e.g., Hochfelder*, 425 U.S. at 206 (*citing Blue Chip*, 421 U.S. at 727-30; *SEC v. National Sec.*, Inc., 393 U.S. 453, 466 (1969)).

[15] 501 U.S. at 1090 n.5 (*citing TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 n.7 (1976) (reserving the same question)).

belief" are actionable under § 14(a), 15 U.S.C. 78n(a), and Rule 14a-9, 17 C.F.R. § 240.14a-9, as false or misleading only if there is proof of (1) subjective "disbelief or undisclosed motivation," and (2) objective falsity. 501 U.S. at 1095-96. Justice Scalia explained the Court's holding as follows:

> As I understand the Court's opinion, the statement "In the opinion of the Directors, this is a high value for the shares" would produce liability if in fact it was not a high value and the Directors knew that. It would not produce liability if in fact it was not a high value but the Directors honestly believed otherwise. The statement "The Directors voted to accept the proposal *because* they believe it offers a high value" would not produce liability if in fact the Directors' genuine motive was quite different — except that it would produce liability if the proposal in fact did not offer a high value and the Directors knew that.[16]

It follows that,

> if: (A) a statement must be subjectively disbelieved in order to be actionable under Section 14(a), a provision that may or may not require scienter,
>
> then: (B) *a fortiori*, under Section 10(b), a provision that clearly requires scienter, plaintiffs must also show subjective disbelief.

Any other result would lead to the anomalous conclusion that statements actionable under Section 10(b), the more restrictive "catchall" provision of the federal securities laws, *Hochfelder*, 425 U.S. at 203, would not be actionable under Section 14(a). Indeed, "[t]here is no indication that Congress intended anyone to be made liable under [under § 10(b)] unless he acted other than in good faith [and]

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[16] 501 U.S. at 1108-09 (Scalia, J., concurring in part and concurring in the judgment).

[t]he catchall provision of § 10(b) should be interpreted no more broadly." *Id.* at 206.[17]

The language of the text, the legislative history, and the structure of the statute therefore each compel the conclusion that subjective knowledge is a prerequisite for liability under Section 10(b). Nevertheless, since *Hochfelder*, eleven of the twelve Circuits have held that various forms of conduct or inaction passing under the generic and ill-defined label of recklessness are sufficient for civil liability under Section 10(b).[18]

The question of whether Section 10(b) liability attaches to reckless behavior thus arises in a posture similar to that presented in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994). The petition in *Central Bank* was granted to "resolve the continuing confusion over the existence and scope of the § 10(b) aiding and abetting action." *Id.* at 1444. Prior to *Central Bank*, this Court had twice reserved that question in the very same cases reserving the questions presented in this case. *See Hochfelder*, 425 U.S. at 191-92 n.7; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983). In the wake of this Court's silence, eleven Courts of Appeal had recognized an implied Section 10(b) private right against aiders and abettors, and no Court of Appeals had denied the existence of such a right. *See Central Bank*, 114 S. Ct. at 1456 n.1 (Stevens, J., dissenting) (collecting cases). Notwithstanding lower court precedent, *Central Bank* held that there is no

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[17]This Court has previously extended holdings from § 14(a)'s proxy antifraud provisions to § 10(b)'s general antifraud provision. *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (adopting for purposes of § 10(b) liability the standard for materiality initially defined under § 14(a) by *TSC*, 426 U.S. at 445).

[18]*See, e.g.*, VIII Louis Loss & Joel Seligman, *Securities Regulation* 3665-67 n.521 (3d ed. 1991) (collecting cases).

implied private § 10(b) cause of action for aiding and abetting.

As was the case in *Central Bank*, the lower courts are in error. The lower courts define recklessness so as to impose liability even when there is no showing of the subjective, "knowing," "intentional," or "willful" intent "to deceive, manipulate or defraud" that is required by the statute. This petition provides an opportunity to correct the error below.

II. IF RECKLESSNESS SUFFICES THEN THE PETITION SHOULD BE GRANTED TO RESOLVE A SPLIT AMONG THE CIRCUITS AND WITH THE S.E.C. REGARDING THE DEFINITION OF RECKLESSNESS.

The lower courts disagree among themselves and with the Securities and Exchange Commission over the proper definition of recklessness. If this Court ultimately concludes that recklessness suffices under Section 10(b), then the Court should resolve the conflict among the circuits by defining the precise contours of recklessness sufficient to establish implied private Section 10(b) liability.[19]

There is "little uniformity . . . among the circuits or even among different panels on the same circuit, on how proof of recklessness should be used to satisfy scienter."[20] The recklessness standards applied by the lower courts are described

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[19]The Court can, of course, avoid this difficult issue — just as it avoided the problem of defining the level of recklessness necessary to establish aiding and abetting liability under § 10(b) in *Central Bank* — by holding that recklessness will not suffice to establish liability.

[20]Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986).

as "highly indeterminate"[21] and "too amorphous."[22] More ominously, this ambiguity allows lower courts to adopt definitions that are "closer to negligence than the type of scienter the Court in *Hochfelder* and *Aaron* might have had in mind."[23]

While some courts apply a "barely reckless" standard, other courts lean toward a "highly reckless" standard.[24] Some courts speak of recklessness as "carelessness approaching indifference,"[25] while other courts look for "a lesser form of intent [rather] than merely a greater degree of ordinary negligence,"[26] and other courts claim to insist on a "more rigorous showing" of "severe recklessness."[27] The Securities and Exchange Commission recognizes the split among the Circuits and adds to the confusion by advocating its own definition of recklessness which conflicts with the dominant formulations applied by the courts below.[28]

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[21] James D. Cox, et al., *Securities Regulation: Cases and Materials* 740 (1991).

[22] 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 84 (2d ed. 1990).

[23] *Id.*

[24] *Id.* at 83.

[25] *Hoffman v. Estabrook & Co.*, 587 F. 2d 509, 516 (1st Cir. 1978).

[26] *Sanders v. John Nuveen & Co.*, 554 F. 2d 790, 793 (7th Cir. 1977), *cert. denied*, 450 U.S. 1005 (1981).

[27] *Cox, et al., supra* note 21, at 740 (quoting *Broad v. Rockwell Int'l. Corp.*, 642 F.2d 929, 961-62 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981)).

[28] The Brief of the Securities and Exchange Commission, *Amicus Curiae*, Regarding Rehearing En Banc at 15-24, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc) (No. 87-3837), reprinted in *The SEC Speaks in 1990* (Practising Law Institute 1990), recognizes the split and describes several of its dimensions. In that brief, the Commission advocates the "common law's conscious indifference

No Circuit better illustrates the confusion over the definition of recklessness than the Ninth which, for years, was notorious as a hotbed of conflicting definitions of recklessness.[29] In an effort to end this confusion, and over the objections of the Securities and Exchange Commission, an en banc court in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 499 U.S. 976 (1991), adopted as the Ninth Circuit's uniform definition of recklessness, the Seventh Circuit's *Sundstrand* standard, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

The *Sundstrand* standard has both an objective and subjective component. The objective component requires a showing of something more than "inexcusable negligence," 553 F. 2d at 1045 & n. 19, and demands that "the danger of misleading buyers . . . [is] so obvious that any reasonable man would be legally bound as knowing." *Id.* at 1045 n.20. The subjective component demands that "the omission must derive from something more egregious than even "white heart/empty head" good faith. *Id.* at 1045. Therefore, if a defendant "genuinely forgot to disclose information or that it never came to his mind" then there can be no finding of

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standard." The Commission also criticizes the Fifth and Eleventh Circuits for requiring a higher standard and challenges the Sixth Circuit for allowing a weaker standard. *Id.* at 15-16, 23. The Commission's proposed common law standard is, however, inconsistent with the *Sundstrand* standard which is "adhered to, albeit with some variation by a majority of the circuits," and the Commission's proposed definition was rejected by the Ninth Circuit. *Hollinger*, 914 F.2d at 1569.

[29] *See Hollinger*, 914 F.2d at 1569 (explaining that the Ninth Circuit had previously "declined to define recklessness" and instead "tried to delineate its contours"). This lack of definition allowed some panels to articulate "a standard of recklessness that is not clearly distinguishable from negligence." *Id.* (citations omitted). The lack of definition also allowed some panels to resort to a "flexible duty" standard that had been specifically rejected in *Hochfelder*. *See, e.g., id.* at 1570 n.11.

recklessness "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20; *see also id.* at 1047 ("an omission caused because [defendant] genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect") (citation omitted).

The Ninth Circuit's effort to achieve uniformity through *Sundstrand* has failed. Some Ninth Circuit panels properly require that both the subjective and objective components of *Sundstrand* be satisfied. For example, in *Kaplan v. Rose,* 49 F.3d 1363 (9th Cir. 1994), *petition for cert. filed,* 63 U.S.L.W. 3849 (U.S. May 10, 1995) (No. 94-1895), the court affirmed a grant of summary judgment in favor of defendants who submitted "declarations of good faith" where the only response by plaintiff was an assertion that the statements at issue "are so false that defendants must have known they were false and must have intended to mislead the public." *Id.* at 1379. As the panel explained, allegations that defendants "should have known" are insufficient to establish scienter on a motion for summary judgment. *Id.* at 1380.

In stark contrast, the panel below improperly applied a "half-*Sundstrand*" standard that ignores *Sundstrand's* critical subjective component. In particular, the panel found that "plaintiffs presented no evidence of the Underwriters' actual knowledge or fraudulent intent." (Petitioners' Appendix at A18). Summary judgment should then have been affirmed as to the issue of scienter because the subjective recklessness required by *Sundstrand* cannot exist in the absence of actual knowledge or fraudulent intent. Summary judgment was, however, reversed because the panel concluded that a jury could find that Petitioners "should have known" of the alleged fraud. (A16, A18). This "should have known" standard, however, constitutes nothing more than the objec-

tive form of "inexcusable negligence" that *Sundstrand* defines as insufficient to establish recklessness.

The danger of such a purely objective standard is clear. "The use of an objective test or formulation which makes a presumption of knowledge or intent on the part of the defendant comes very close to the legal formulations of negligence and gross negligence. In accordance with the decision in *Hochfelder,* however, honesty in fact and good faith would form complete defenses to liability.... Where an objective test is used, providing that the defendant should or must have known of the facts, it would seem to be in direct contradiction to a defense based on honesty in fact or good faith." 69A Am. Jur. 2d *Securities Regulation-Federal* § 1284, at 394 (1993).

This danger is realized by the decision below. The petition should be granted so that this Court can resolve the conflicts among the Circuits and among panels of the same Circuit, and articulate a definition of recklessness that more closely incorporates the standard of scienter compelled by the statute.

III. POLICY CONSIDERATIONS SUPPORT GRANT OF THE PETITION.

The dangers of vexatious litigation under the implied private Section 10(b) cause of action are well known to this Court.[30] The uncertainty over Section 10(b) liability for reckless conduct compounds these dangers because it makes courts "reluctant to grant summary judgment in 10b-5

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[30]See, *e.g., Blue Chip,* 421 U.S. at 739 (litigation under § 10(b) "presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general"); *Central Bank,* 114 S. Ct. at 1454 (noting that these dangers force "secondary actors to expend large sums even for pretrial defense and the negotiation of settlements").

cases,"[31] and as long as a plaintiff can "prevent the suit from being resolved against him by dismissal or summary judgment" the plaintiff can extract a "settlement value . . . out of any proportion to [the case's] prospect[s] of success at trial."[32]

"Judge Friendly, who was not given to hyperbole, called settlements induced by a small probability of an immense judgment in a class action 'blackmail settlements.' " *In re Rhone-Poulenc Rorer Inc.*, 51 F. 3d 1293, 1298 (7th Cir. 1995) (*citing* Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973)). The federal securities laws are ripe for such "blackmail settlements" because defendants are generally unwilling to risk financial ruin on the outcome of a single trial.[33] The prospect of producing such settlements can also inspire plaintiff class action counsel to file strike suits in which the probability of a successful verdict is remote.[34] A clear articulation that liability under Sec-

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[31] 2 Hazen, *supra* note 22, § 13.4, at 85.

[32] *Blue Chip*, 421 U.S. at 740.

[33] *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 528-34 (1991); Douglas M. Schwab, *Congress, Corporations and Shareholder Class Actions*, The Recorder, Mar. 23, 1995, at 7 ("The fundamental reason [Rule 10b-5] cases are capable of abuse is that almost every one presents the risk of bankruptcy. . . . It is a rare board that will seek vindication in court and risk a jury verdict resulting in bankruptcy when the company can escape for less than $2 million of its own money [added to insurance proceeds]. So the case settles.").

[34] *See, e.g.*, Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2084-86 (1995) (describing plaintiff incentives to file strike suits in which "defense costs are far larger than those of prosecution"); Joseph A. Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727, 739-43 (1995) (collecting and analyzing data that compare litigation defense costs and the size of settlements in securities fraud actions).

tion 10(b) attaches only to conduct with scienter, and that recklessness does not constitute scienter, would enhance the chances for early dismissal of weak cases and reduce the incidence of Judge Friendly's "blackmail settlements."

A clear articulation that recklessness does not give rise to liability in implied private Section 10(b) litigation would also address the "ripple effects" generated by "uncertainty and excessive litigation" under Section 10(b).

> For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.[35]

Consistent with this Court's prediction, recent reports indicate that auditors are dropping ever larger numbers of clients because of the risk of securities fraud litigation. "New companies, which have a particularly high chance of failure, are affected most, because almost nothing triggers lawsuits against accountants faster than company failures."[36]

The mere suggestion that this Court grant a petition to consider the possibility that reckless behavior does not give rise to Section 10(b) liability may raise substantial concern among advocates of an expansive reading of the federal securities laws. These concerns are, however, easily exaggerated.

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[35] *Central Bank*, 114 S. Ct. at 1454.

[36] Lee Berton, *Big Accounting Firms Weed Out Risky Clients*, Wall St. J., June 26, 1995, at B1.

The Securities and Exchange Commission's enforcement program will be largely unaffected by any ruling in this case because the Commission will remain able to attack reckless and negligent behavior in the sale of securities under Sections 17(a)(2) and (3) of the Securities Act of 1933. 15 U.S.C. § 77q(a)(2),(3).[37] Private party plaintiffs will also remain able to pursue defendants whose conduct evinces "a mental state embracing intent to deceive." Moreover, many defendants who have been charged with serious forms of recklessness that satisfy *Sundstrand's* objective and subjective standards are likely to find that their conduct will also support an inference of scienter under *Hochfelder.* Indeed, in the wake of *Central Bank*, the Securities and Exchange Commission made clear that it and private party litigants will continue to prosecute as primary violations of Section 10(b) certain forms of conduct that had been traditionally denominated as aiding and abetting.[38] This

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[37] Sections 17(a)(2) and (3) reach negligence and recklessness in the sale, but not in the purchase, of securities. *Aaron*, 446 U.S. at 697. Section 10(b) addresses fraud in both the purchase and sale of securities. A holding that recklessness is not sufficient for liability under § 10(b) might therefore restrict the Commission's ability to pursue fraud in the purchase of securities to cases involving scienter, not recklessness. It is difficult to conceive of realistic scenarios in which a party perpetrates a fraud through the reckless, non-scienter based purchase — not sale — of securities, and we are unaware of any such prosecutions in recent years. Concerns over the Commission's enforcement program therefore seem more theoretical than real. The Court could, however, limit even this remote consequence by basing its holding solely on the implied nature of the private § 10(b) right and reserving for a later case the question of whether recklessness suffices in Commission enforcement proceedings under § 10(b).

[38] *See, e.g., Concerning the* Central Bank of Denver *Decision Before the Subcomm. on Securities of the Senate Comm. on Housing and Urban Affairs*, 103d Cong., 2d Sess. (1994) (testimony of Arthur Levitt, Chairman, SEC), *available in* LEXIS, Legis Library, Cngtst file; Diana Henriques, *Towers Investors Try Aggressive New Legal Tack,*

Court expected and invited such a response when it observed that the "absence of Section 10(b) aiding and abetting liability does not mean that secondary actors are always free from liability under the securities acts," and that such actors could be found liable as primary violators, "assuming *all* of the requirements for primary liability under Rule 10b-5 are met." *Central Bank*, 114 S. Ct. at 1455. Plaintiffs and lower courts are acting as this Court anticipated, and primary liability under Section 10(b) is being attached to parties who have traditionally been pursued as aiders and abettors.[39]

A holding that limits Section 10(b) liability to scienter and establishes that recklessness does not suffice will therefore preserve plaintiffs' rights to attack conduct that evinces conscious fraud of the sort that Congress intended to proscribe under Section 10(b). It will also promote the judiciary's ability to filter out weaker claims that are unable to establish the essential elements of "knowing" or "intentional" misconduct under the federal securities laws. This is precisely the category of claims that should be thrown out of court as inconsistent with statutory language and legislative intent and prone to the danger of vexatious litigation giving rise to "blackmail settlements."

N.Y. Times, June 30, 1994, at D1; Tom Weidlich, *Professionals Still At Risk*, Nat'l L.J., July 18, 1994, at A6.

[39] *See, e.g., In re U.S.A. Classic Sec. Litig.*, No. 93 Civ 6667 (JSM), 1995 U.S. Dist. LEXIS 8327, at *13 (S.D.N.Y. June 19, 1995) (finding that plaintiffs' allegations were sufficient to establish primary liability and that the cause of action is not precluded by *Central Bank*). *See also* Edward Brodsky, *Aiding and Abetting Claims Under Rule 10b-5*, N.Y. L. J., June 14, 1995, at 3 (describing recent decisions in which traditional aiding and abetting activity has been attacked as a primary violation).

CONCLUSION

For the foregoing reasons, *amici curiae* request this Court to grant the petition for a writ of certiorari.

Respectfully submitted,

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(4)

No. 94-2027

In The Supreme Court

OF THE

United States

OCTOBER TERM 1994

MONTGOMERY SECURITIES and PAINEWEBBER INC.,
Petitioners,
VS.
RICHARD B. DANNENBERG, *et. al.,* On Behalf of Themselves and all others Similarly Situated.
Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF AND BRIEF OF THE AMERICAN BANKERS ASSOCIATION, THE AMERICAN ELECTRONICS ASSOCIATION, THE ASSOCIATION OF PUBLICLY TRADED COMPANIES, THE NATIONAL ASSOCIATION OF MANUFACTURERS, AND THE SECURITIES INDUSTRY ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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July 8, 1995

BOWNE OF PALO ALTO, INC. (415) 858-1800

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34pp

No. 94-2027

In The Supreme Court

OF THE

United States

OCTOBER TERM 1994

MONTGOMERY SECURITIES and PAINEWEBBER INC.,
Petitioners,
VS.
RICHARD B. DANNENBERG, *et. al.,* On Behalf of Themselves and all others Similarly Situated.
Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For the Ninth Circuit

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Pursuant to Rule 37.2 of the Rules of this Court, *amici,* the American Bankers Association ("ABA"), the American Electronics Association ("AEA"), the Association of Publicly Traded Companies ("APTC"), the National Association of Manufacturers ("NAM"), and the Securities Industry Association ("SIA"), respectfully move for leave

to file the attached Brief of *Amici Curiae* in Support of the Petition for Writ of Certiorari. Petitioners Montgomery Securities and PaineWebber Incorporated have consented to the filing of the brief. This motion is necessary because Respondents have denied consent.

The *amici,* non-profit trade associations, share a concern regarding the burdens imposed by vexatious litigation brought under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5. 17 C.F.R. § 240.10b-5. *See Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 739 (1975); *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,* 114 S. Ct. 1439, 1454 (1994). *Amici* have a substantial interest in limiting abusive litigation under the federal securities laws and in clarifying the standard of liability under Section 10(b), the most frequently invoked civil liability provision of the Exchange Act.

The ABA, a not-for-profit corporation, is the largest national trade association of the commercial banking industry in the United States. Member banks of the ABA are located in each of the fifty states and the District of Columbia. ABA members have been and are currently subject to claims under Section 10(b) implicating the questions presented in the petition for *certiorari.*

The AEA represents approximately 3,000 companies in 44 states, spanning the breadth of the electronics industry, including the semiconductor, software, computer, telecommunications, networks, and systems fields. Members of the AEA have been and are currently subject to claims raising the questions presented in the petition.

APTC's membership of more than 500 corporations includes the newest and smallest publicly traded firms as well as larger, more mature corporations. APTC represents its members' interests without regard to industry affiliation or

geographic location, and concentrates on issues of concern to publicly traded corporations. APTC members have been targets of Section 10(b) private securities fraud litigation. APTC members recognize from experience that the burdens imposed by vexatious securities fraud litigation can raise the cost of capital and divert resources from productive activity to nonproductive litigation-related matters.

The NAM is the nation's oldest and largest broad-based industrial trade association. Its more than 13,500 member companies and subsidiaries, including 10,000 small manufacturers, employ approximately eighty-five percent of all manufacturing workers and produce over eighty percent of the nation's manufactured goods. More than 158,000 additional businesses are affiliated with the NAM through its Associations Council and National Industrial Council. The NAM has a vital interest in the reasonable enforcement of the securities laws. The NAM believes spurious securities litigation has the potential to impact the competitiveness and profitability of all publicly traded businesses.

The SIA is the principal trade association of the securities industry. Its members include more than 700 broker-dealers and investment banking firms in the United States and Canada. When members of the SIA underwrite public offerings of securities that become the subject of class action lawsuits alleging claims under Section 10(b), they are often included among the parties named as defendants. Even when such litigation is ultimately found to be without merit, the litigation is expensive to defend and can injure defendants' reputation.

Amici submit that the decision of the court of appeals in this case raises a significant and recurring issue regarding the required mental state for violations of Section 10(b) and Rule 10b-5, and will subject defendants to unwarranted liability for innocent behavior. Many members of *amici* trade associations are located within the jurisdiction of the

Ninth Circuit and stand to be particularly affected by the decision below.

The issues presented by this case are of exceptional importance to *amici* and to their members. *Amici* seek to promote a consistent interpretation of the federal securities laws that retains fidelity to the statutory language and legislative history. *Amici* therefore respectfully seek leave of this Court to file the attached brief in support of the petition for writ of certiorari.

Respectfully submitted,

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QUESTIONS PRESENTED

1. "[W]hether, in some circumstances, reckless behavior is sufficient for civil liability under" Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976) (reserving this question); *see also Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) (same).

2. If reckless behavior can, in some circumstances, suffice for implied civil liability under Section 10(b) and Rule 10b-5, what definition of "recklessness" establishes such liability?

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INTERESTS OF *AMICI CURIAE*

This brief *amici curiae*, accompanied by motion for leave to file under Rule 37.2, is presented by the American Bankers Association, the American Electronics Association, the Association of Publicly Traded Companies, the National Association of Manufacturers, and the Securities Industry Association in support of the petition of Montgomery Securities and PaineWebber Incorporated for a writ of *certiorari* to review the decision of the United States Court of Appeals for the Ninth Circuit in this case.

As detailed in the motion accompanying this brief, this case is of great significance to the trade associations appearing as *amici*, as well as to their individual members. Members of *amici* trade associations have been subject to lawsuits that raise the specific questions presented for review in this case. Moreover, petitioners in this case are both members of *amicus* Securities Industry Association. A substantial volume of litigation raising the questions presented in this petition has arisen and will continue to arise in the Ninth Circuit.

REASONS FOR GRANTING THE WRIT

The Petition for a Writ of Certiorari should be granted for three distinct reasons.

This Court has twice reserved the question of whether recklessness constitutes a state of mind sufficient to impose liability under the Section 10(b) implied private right of action. 15 U.S.C. § 78j(b). Neither the text, nor the structure, nor the legislative history of the statute support such liability. The petition should be granted so that this Court can correct the error below and establish that recklessness is not sufficient to establish liability under the implied Section 10(b) private right of action. The error below is not

unique and arises in a large number of cases across all Circuits.

Second, the Circuits are split over the definition of recklessness that supports implied private Section 10(b) liability and the Securities and Exchange Commission advocates a definition inconsistent with the approach adopted by the majority of Circuits. Confusing definitions and contradictory results abound. The petition should be granted so that, if this Court holds that recklessness suffices to establish Section 10(b) liability, this Court can articulate a uniform definition of recklessness.

Third, vexatious litigation under Section 10(b) imposes substantial costs on the economy. The financial risk inherent in securities fraud litigation can also force innocent defendants to enter into expensive settlement agreements. An interpretation of Section 10(b) that retains fidelity to the statutory text by requiring a showing of scienter — and not any lesser state of mind — will preserve the Securities and Exchange Commission's enforcement authority, deter vexatious litigation, and keep open the courthouse door to private party plaintiffs harmed by the conscious frauds against which Section 10(b) was designed to protect.

ARGUMENT

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), this Court held that scienter is a necessary element of an implied private action for damages under Section 10(b) and Rule 10b-5. 17 C.F.R. § 240.10b-5. This Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 194 n.12. This Court has, however, twice reserved "the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id. See also Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.4 (1983) ("we have explicitly left open the

question whether recklessness satisfies the scienter requirement").

This Court's silence of nearly two decades has promoted substantial splits among the Circuits. These splits have spawned widespread confusion and fostered much litigation. More fundamentally, this Court's silence has allowed the lower courts to interpret Section 10(b) in a manner that is inconsistent with the text of the statute and that conflicts with its legislative history. The scope of liability for reckless conduct in an implied private right of action under Section 10(b) stands as a recurring and significant unanswered question in the interpretation of the federal securities laws. This petition presents a particularly felicitous opportunity to resolve that question.

I. RECKLESS BEHAVIOR IS INSUFFICIENT FOR CIVIL LIABILITY UNDER THE IMPLIED § 10(b) PRIVATE RIGHT.

Section 10(b) "does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy. . . ." *Hochfelder*, 425 U.S. at 196. While the implied private right of action under Section 10(b) is "beyond peradventure," *Huddleston*, 459 U.S. at 380, the rationale for the right's existence has never been articulated by this Court.[1]

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[1]The Supreme Court recognized the implied § 10(b) private right of action "with virtually no discussion." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975). The law governing the implication of private rights has changed substantially since the § 10(b) private right was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). Every rationale relied on by the lower courts in creating the implied right has since been repudiated by this Court, and there is substantial doubt that this Court would imply a private § 10(b) right of action for money damages if the issue presented itself on a clean slate. *See* Joseph A. Grundfest, *Disimplying Private Rights of Action*

This Court has also "made no pretense that it was Congress' design to provide the remedy afforded" by the implied Section 10(b) cause of action,[2] and there is, at most, a congressional "acknowledgment of the Rule 10b-5 action without any further expression of legislative intent to define it."[3] Indeed, this Court has recognized a sea change

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[2] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 359 (1991). Accord, Brief for the Securities and Exchange Commission as *Amicus Curiae* Supporting Respondents at 24 n.32, *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (No. 93-404), reprinted in *The SEC Speaks in 1995* at 872, 895 n.32 (Practising Law Institute 1995).

[3] *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2089 (1993). "Congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction. . . ." *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439, 1453 (1994) (quotation omitted). The Senate has recently passed legislation that prescribes a pleading standard for § 10(b) private actions but specifically avoids any definition of the element of scienter required to establish a § 10(b) violation. S. 240, 104th Cong., 1st Sess. § 104(b) (June 28, 1995) (referring generally to private actions arising under the Securities Exchange Act that require proof that "defendant acted with a particular state of mind" without defining any such state of mind). *See also* 144 Cong. Rec. S 9171 (daily ed. June 27, 1995) (remarks of Senator Specter, sponsor of the amendment adopted as § 104(b), explaining that the amendment relates solely to pleading requirements). The House of Representatives has recently passed legislation that would expand the definition of scienter to include and define recklessness. H.R. 1058, 104th Cong., 1st Sess. § 4 (1995) (Mar. 12, 1995).

The uncertain potential for Congressional action — especially when the Senate bill preserves the questions presented for review — is not an impediment to the grant of the petition. This Court has very recently granted *certiorari* in cases raising questions that could be mooted by currently pending legislation. *See United States v. Chesapeake & Potomac Tel. Co. of Va.*, (No. 94-1893) and *National Cable Television Ass'n. v. Bell Atlantic Corp.*, (No. 94-1900) (presenting question of constitutionality of cross-ownership restrictions barring local telephone companies from entering cable television business), *petitions for cert. granted*, 63 U.S.L.W. 3906 (U.S. June 27, 1995). *See also* S. 652, 104th

in its approach to the interpretation of the implied Section 10(b) right and has emphasized that the implied nature of the right does not provide license to abandon "adherence to the statutory language." *Central Bank*, 114 S. Ct. at 1446.[4]

A. Neither the Text Nor the Legislative History of Section 10(b) Support Liability For Reckless Behavior

"The starting point in every case involving construction of a statute is the language itself."[5] Because Congress "did not create a private § 10(b) cause of action and had no occasion to provide guidance about the elements of a private liability scheme," this Court has been forced "to infer how the 1934 Congress would have addressed the issue[s] had the 10b-5

Cong., 1st Sess. § 202 (June 15, 1995) (eliminating cable and telephone company cross-ownership restrictions). The securities bills passed by each chamber would, moreover, apply only to lawsuits filed after the legislation's effective date and would leave hundreds of pending cases alleging billions of dollars in damages to be resolved under incorrect and conflicting precedent.

[4] *See also Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102-03 (1991) (recognizing that *Cort v. Ash*, 422 U.S. 66, 78 (1975), and *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575 (1979), emphasize the importance of an inquiry into Congressional intent to authorize a private cause of action and that this emphasis on Congressional intent became clear only after the § 10(b) and § 14(a), 15 U.S.C. § 78n(a), implied private rights had been recognized by the Court).

[5] *Hochfelder*, 425 U.S. at 197 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). *See also Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1074 (1995) (Thomas, J., dissenting); *Central Bank*, 114 S. Ct. at 1446; *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472 (1977).

action been included as an express provision in the 1934 Act."[6]

The inference from the language of the statute is clear. Congress would not have created Section 10(b) liability for reckless behavior.

Section 10(b) prohibits "any manipulative or deceptive device or contrivance" in contravention of rules adopted by the Commission pursuant to Section 10(b)'s delegated authority. The terms "manipulative," "device," and "contrivance" "make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." *Hochfelder*, 425 U.S. at 199. The intent was to "proscribe *knowing* or *intentional* misconduct." *Id.* (emphasis supplied). In addition, the "use of the word "manipulative" is especially significant [because] [i]t is and was virtually a term of art when used in connection with securities markets. It connotes *intentional* or *willful* conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Id.* (footnote omitted) (emphasis supplied).

A market cannot be manipulated in violation of the Exchange Act through inadvertence or with lack of subjective consciousness. Nor can one construct a device or contrivance absent subjective awareness. The words, "manipulative," "device," or "contrivance," by their very nature, require conscious intent and connote purposive activity.[7] The mental state consistent with the statute can be achieved

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[6] *Central Bank*, 114 S. Ct. at 1441-42 (quoting *Musick, Peeler*, 113 S. Ct. at 2089-90).

[7] *See Hochfelder*, 425 U.S. at 199 n. 20 ("device" means " 'that which is devised, or formed by design; a contrivance; an invention; project; scheme; often a scheme to deceive; a stratagem; an artifice' ") (quoting Webster's International Dictionary (2d ed. 1934)); *id.* (defining "contrivance" as " '[a] thing contrived or used in contrivance; a scheme,

only if a defendant acts with a state of mind "embracing" — an active verb — "intent" — requiring a conscious state of mind — "to deceive, manipulate or defraud."[8]

The legislative history compels the same conclusion. "[T]here is no indication that § 10(b) was intended to proscribe conduct not involving scienter." *Hochfelder*, 425 U.S. at 202; *see also Aaron v. SEC*, 446 U.S. 680, 691 (1980) (same). Indeed, "[i]n considering specific manipulative practices left to Commission regulation . . . the [Congressional] reports indicate that liability would not attach absent scienter, supporting the conclusion that Congress intended no lesser standard under § 10(b)." *Hochfelder*, 425 U.S. at 204. Congress thus "evidenced a purpose to proscribe only *knowing* and *intentional* misconduct." *Aaron*, 446 U.S. at 690 (emphasis supplied).

B. The Structure of the Statute Underscores That There Is No Section 10(b) Liability for Recklessness

In drafting the federal securities laws, Congress knew how to use specific language to impose liability for reckless or negligent behavior and how to create strict liability for violations of the federal securities laws.[9] But Congress did not use such language to impose Section 10(b) liability on

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[8] *Hochfelder*, 425 U.S. at 193 n.12. *Cf. Santa Fe Industries*, 430 U.S. at 478; *Schreiber v. Burlington Northern Inc.*, 472 U.S. 1, 5-8 (1985).

[9] Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, for example, imposes strict liability on the issuer for material misstatements or omissions in a registration statement and a "sliding scale" negligence standard on other participants in the offering process. *See Hochfelder*, 425 U.S. at 208. Sections 17(a)(2) and (3) of the Securities Act, 15 U.S.C. § 77q(a)(2),(3), impose liability for negligent or reckless conduct in the sale of securities. *Aaron*, 446 U.S. at 697.

reckless behavior. Therefore, just as there is no liability for aiding and abetting a violation of Section 10(b) because Congress knew how to create such liability but did not;[10] and just as there is no liability under Section 12(1) of the Securities Act, 17 U.S.C. § 77l(1) for participants who are merely collateral to an offer or sale because Congress knew how to create such liability but did not;[11] and just as there is no remedy under Section 10(b) for those who neither purchase nor sell securities because Congress knew how to create such a remedy but did not;[12] there can be no liability for reckless conduct under Section 10(b) because Congress clearly knew how to impose liability for reckless behavior but did not.

This Court has, moreover, emphasized that the securities laws "should not be read as a series of unrelated and isolated provisions."[13] The federal securities laws are to be interpreted consistently and as part of an interrelated whole.[14] In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991), the Court reserved "the question whether scienter was necessary for liability under § 14(a)."[15] The Court nonetheless held that statements of "reasons, opinions or

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[10] *Central Bank*, 114 S. Ct. at 1448 ("Congress knew how to impose aiding and abetting liability when it chose to do so.") (citing statutes).

[11] *Pinter v. Dahl*, 486 U.S. 622, 650 & n.26 (1988) (Congress knew how to provide liability for collateral participants in securities offerings when it chose to do so).

[12] *Blue Chip*, 421 U.S. at 734. ("When Congress wished to provide a remedy for those who neither purchase nor sell securities, it had little trouble doing so expressly.") .

[13] *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1067 (1995).

[14] *See, e.g., Hochfelder*, 425 U.S. at 206 (*citing Blue Chip*, 421 U.S. at 727-30; *SEC v. National Sec.*, Inc., 393 U.S. 453, 466 (1969)).

[15] 501 U.S. at 1090 n.5 (*citing TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 n.7 (1976) (reserving the same question)).

belief" are actionable under § 14(a), 15 U.S.C. 78n(a), and Rule 14a-9, 17 C.F.R. § 240.14a-9, as false or misleading only if there is proof of (1) subjective "disbelief or undisclosed motivation," and (2) objective falsity. 501 U.S. at 1095-96. Justice Scalia explained the Court's holding as follows:

> As I understand the Court's opinion, the statement "In the opinion of the Directors, this is a high value for the shares" would produce liability if in fact it was not a high value and the Directors knew that. It would not produce liability if in fact it was not a high value but the Directors honestly believed otherwise. The statement "The Directors voted to accept the proposal *because* they believe it offers a high value" would not produce liability if in fact the Directors' genuine motive was quite different — except that it would produce liability if the proposal in fact did not offer a high value and the Directors knew that.[16]

It follows that,

> if: (A) a statement must be subjectively disbelieved in order to be actionable under Section 14(a), a provision that may or may not require scienter,
>
> then: (B) *a fortiori*, under Section 10(b), a provision that clearly requires scienter, plaintiffs must also show subjective disbelief.

Any other result would lead to the anomalous conclusion that statements actionable under Section 10(b), the more restrictive "catchall" provision of the federal securities laws, *Hochfelder*, 425 U.S. at 203, would not be actionable under Section 14(a). Indeed, "[t]here is no indication that Congress intended anyone to be made liable under [under § 10(b)] unless he acted other than in good faith [and]

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[16] 501 U.S. at 1108-09 (Scalia, J., concurring in part and concurring in the judgment).

[t]he catchall provision of § 10(b) should be interpreted no more broadly." *Id.* at 206.[17]

The language of the text, the legislative history, and the structure of the statute therefore each compel the conclusion that subjective knowledge is a prerequisite for liability under Section 10(b). Nevertheless, since *Hochfelder*, eleven of the twelve Circuits have held that various forms of conduct or inaction passing under the generic and ill-defined label of recklessness are sufficient for civil liability under Section 10(b).[18]

The question of whether Section 10(b) liability attaches to reckless behavior thus arises in a posture similar to that presented in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994). The petition in *Central Bank* was granted to "resolve the continuing confusion over the existence and scope of the § 10(b) aiding and abetting action." *Id.* at 1444. Prior to *Central Bank*, this Court had twice reserved that question in the very same cases reserving the questions presented in this case. *See Hochfelder*, 425 U.S. at 191-92 n.7; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983). In the wake of this Court's silence, eleven Courts of Appeal had recognized an implied Section 10(b) private right against aiders and abettors, and no Court of Appeals had denied the existence of such a right. *See Central Bank*, 114 S. Ct. at 1456 n.1 (Stevens, J., dissenting) (collecting cases). Notwithstanding lower court precedent, *Central Bank* held that there is no

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[17] This Court has previously extended holdings from § 14(a)'s proxy antifraud provisions to § 10(b)'s general antifraud provision. *See, e.g., Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (adopting for purposes of § 10(b) liability the standard for materiality initially defined under § 14(a) by *TSC*, 426 U.S. at 445).

[18] *See, e.g.*, VIII Louis Loss & Joel Seligman, *Securities Regulation* 3665-67 n.521 (3d ed. 1991) (collecting cases).

implied private § 10(b) cause of action for aiding and abetting.

As was the case in *Central Bank*, the lower courts are in error. The lower courts define recklessness so as to impose liability even when there is no showing of the subjective, "knowing," "intentional," or "willful" intent "to deceive, manipulate or defraud" that is required by the statute. This petition provides an opportunity to correct the error below.

II. IF RECKLESSNESS SUFFICES THEN THE PETITION SHOULD BE GRANTED TO RESOLVE A SPLIT AMONG THE CIRCUITS AND WITH THE S.E.C. REGARDING THE DEFINITION OF RECKLESSNESS.

The lower courts disagree among themselves and with the Securities and Exchange Commission over the proper definition of recklessness. If this Court ultimately concludes that recklessness suffices under Section 10(b), then the Court should resolve the conflict among the circuits by defining the precise contours of recklessness sufficient to establish implied private Section 10(b) liability.[19]

There is "little uniformity . . . among the circuits or even among different panels on the same circuit, on how proof of recklessness should be used to satisfy scienter."[20] The recklessness standards applied by the lower courts are described

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[19]The Court can, of course, avoid this difficult issue — just as it avoided the problem of defining the level of recklessness necessary to establish aiding and abetting liability under § 10(b) in *Central Bank* — by holding that recklessness will not suffice to establish liability.

[20]Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986).

as "highly indeterminate"[21] and "too amorphous."[22] More ominously, this ambiguity allows lower courts to adopt definitions that are "closer to negligence than the type of scienter the Court in *Hochfelder* and *Aaron* might have had in mind."[23]

While some courts apply a "barely reckless" standard, other courts lean toward a "highly reckless" standard.[24] Some courts speak of recklessness as "carelessness approaching indifference,"[25] while other courts look for "a lesser form of intent [rather] than merely a greater degree of ordinary negligence,"[26] and other courts claim to insist on a "more rigorous showing" of "severe recklessness."[27] The Securities and Exchange Commission recognizes the split among the Circuits and adds to the confusion by advocating its own definition of recklessness which conflicts with the dominant formulations applied by the courts below.[28]

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[21] James D. Cox, et al., *Securities Regulation: Cases and Materials* 740 (1991).

[22] 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 84 (2d ed. 1990).

[23] *Id.*

[24] *Id.* at 83.

[25] *Hoffman v. Estabrook & Co.*, 587 F. 2d 509, 516 (1st Cir. 1978).

[26] *Sanders v. John Nuveen & Co.*, 554 F. 2d 790, 793 (7th Cir. 1977), *cert. denied*, 450 U.S. 1005 (1981).

[27] *Cox, et al., supra* note 21, at 740 (quoting *Broad v. Rockwell Int'l. Corp.*, 642 F.2d 929, 961-62 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981)).

[28] The Brief of the Securities and Exchange Commission, *Amicus Curiae*, Regarding Rehearing En Banc at 15-24, *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc) (No. 87-3837), reprinted in *The SEC Speaks in 1990* (Practising Law Institute 1990), recognizes the split and describes several of its dimensions. In that brief, the Commission advocates the "common law's conscious indifference

No Circuit better illustrates the confusion over the definition of recklessness than the Ninth which, for years, was notorious as a hotbed of conflicting definitions of recklessness.[29] In an effort to end this confusion, and over the objections of the Securities and Exchange Commission, an en banc court in *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied,* 499 U.S. 976 (1991), adopted as the Ninth Circuit's uniform definition of recklessness, the Seventh Circuit's *Sundstrand* standard, *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977).

The *Sundstrand* standard has both an objective and subjective component. The objective component requires a showing of something more than "inexcusable negligence," 553 F. 2d at 1045 & n. 19, and demands that "the danger of misleading buyers . . . [is] so obvious that any reasonable man would be legally bound as knowing." *Id.* at 1045 n.20. The subjective component demands that "the omission must derive from something more egregious than even "white heart/empty head" good faith. *Id.* at 1045. Therefore, if a defendant "genuinely forgot to disclose information or that it never came to his mind" then there can be no finding of

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standard." The Commission also criticizes the Fifth and Eleventh Circuits for requiring a higher standard and challenges the Sixth Circuit for allowing a weaker standard. *Id.* at 15-16, 23. The Commission's proposed common law standard is, however, inconsistent with the *Sundstrand* standard which is "adhered to, albeit with some variation by a majority of the circuits," and the Commission's proposed definition was rejected by the Ninth Circuit. *Hollinger*, 914 F.2d at 1569.

[29] *See Hollinger*, 914 F.2d at 1569 (explaining that the Ninth Circuit had previously "declined to define recklessness" and instead "tried to delineate its contours"). This lack of definition allowed some panels to articulate "a standard of recklessness that is not clearly distinguishable from negligence." *Id.* (citations omitted). The lack of definition also allowed some panels to resort to a "flexible duty" standard that had been specifically rejected in *Hochfelder*. *See, e.g., id.* at 1570 n.11.

recklessness "even though the proverbial 'reasonable man' would never have forgotten." *Id.* at 1045 n.20; *see also id.* at 1047 ("an omission caused because [defendant] genuinely forgot about these facts would not be actionable, even if such an omission derived from inexcusable neglect") (citation omitted).

The Ninth Circuit's effort to achieve uniformity through *Sundstrand* has failed. Some Ninth Circuit panels properly require that both the subjective and objective components of *Sundstrand* be satisfied. For example, in *Kaplan v. Rose,* 49 F.3d 1363 (9th Cir. 1994), *petition for cert. filed,* 63 U.S.L.W. 3849 (U.S. May 10, 1995) (No. 94-1895), the court affirmed a grant of summary judgment in favor of defendants who submitted "declarations of good faith" where the only response by plaintiff was an assertion that the statements at issue "are so false that defendants must have known they were false and must have intended to mislead the public." *Id.* at 1379. As the panel explained, allegations that defendants "should have known" are insufficient to establish scienter on a motion for summary judgment. *Id.* at 1380.

In stark contrast, the panel below improperly applied a "half-*Sundstrand*" standard that ignores *Sundstrand's* critical subjective component. In particular, the panel found that "plaintiffs presented no evidence of the Underwriters' actual knowledge or fraudulent intent." (Petitioners' Appendix at A18). Summary judgment should then have been affirmed as to the issue of scienter because the subjective recklessness required by *Sundstrand* cannot exist in the absence of actual knowledge or fraudulent intent. Summary judgment was, however, reversed because the panel concluded that a jury could find that Petitioners "should have known" of the alleged fraud. (A16, A18). This "should have known" standard, however, constitutes nothing more than the objec-

tive form of "inexcusable negligence" that *Sundstrand* defines as insufficient to establish recklessness.

The danger of such a purely objective standard is clear. "The use of an objective test or formulation which makes a presumption of knowledge or intent on the part of the defendant comes very close to the legal formulations of negligence and gross negligence. In accordance with the decision in *Hochfelder,* however, honesty in fact and good faith would form complete defenses to liability. . . . Where an objective test is used, providing that the defendant should or must have known of the facts, it would seem to be in direct contradiction to a defense based on honesty in fact or good faith." 69A Am. Jur. 2d *Securities Regulation-Federal* § 1284, at 394 (1993).

This danger is realized by the decision below. The petition should be granted so that this Court can resolve the conflicts among the Circuits and among panels of the same Circuit, and articulate a definition of recklessness that more closely incorporates the standard of scienter compelled by the statute.

III. POLICY CONSIDERATIONS SUPPORT GRANT OF THE PETITION.

The dangers of vexatious litigation under the implied private Section 10(b) cause of action are well known to this Court.[30] The uncertainty over Section 10(b) liability for reckless conduct compounds these dangers because it makes courts "reluctant to grant summary judgment in 10b-5

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[30]See, *e.g., Blue Chip,* 421 U.S. at 739 (litigation under § 10(b) "presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general"); *Central Bank,* 114 S. Ct. at 1454 (noting that these dangers force "secondary actors to expend large sums even for pretrial defense and the negotiation of settlements").

cases,"[31] and as long as a plaintiff can "prevent the suit from being resolved against him by dismissal or summary judgment" the plaintiff can extract a "settlement value . . . out of any proportion to [the case's] prospect[s] of success at trial."[32]

"Judge Friendly, who was not given to hyperbole, called settlements induced by a small probability of an immense judgment in a class action 'blackmail settlements.' " *In re Rhone-Poulenc Rorer Inc.*, 51 F. 3d 1293, 1298 (7th Cir. 1995) (*citing* Henry J. Friendly, *Federal Jurisdiction: A General View* 120 (1973)). The federal securities laws are ripe for such "blackmail settlements" because defendants are generally unwilling to risk financial ruin on the outcome of a single trial.[33] The prospect of producing such settlements can also inspire plaintiff class action counsel to file strike suits in which the probability of a successful verdict is remote.[34] A clear articulation that liability under Sec-

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[31] 2 Hazen, *supra* note 22, § 13.4, at 85.

[32] *Blue Chip*, 421 U.S. at 740.

[33] *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 528-34 (1991); Douglas M. Schwab, *Congress, Corporations and Shareholder Class Actions*, The Recorder, Mar. 23, 1995, at 7 ("The fundamental reason [Rule 10b-5] cases are capable of abuse is that almost every one presents the risk of bankruptcy. . . . It is a rare board that will seek vindication in court and risk a jury verdict resulting in bankruptcy when the company can escape for less than $2 million of its own money [added to insurance proceeds]. So the case settles.").

[34] *See, e.g.*, Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2084-86 (1995) (describing plaintiff incentives to file strike suits in which "defense costs are far larger than those of prosecution"); Joseph A. Grundfest, *Why Disimply?*, 108 Harv. L. Rev. 727, 739-43 (1995) (collecting and analyzing data that compare litigation defense costs and the size of settlements in securities fraud actions).

tion 10(b) attaches only to conduct with scienter, and that recklessness does not constitute scienter, would enhance the chances for early dismissal of weak cases and reduce the incidence of Judge Friendly's "blackmail settlements."

A clear articulation that recklessness does not give rise to liability in implied private Section 10(b) litigation would also address the "ripple effects" generated by "uncertainty and excessive litigation" under Section 10(b).

> For example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute.[35]

Consistent with this Court's prediction, recent reports indicate that auditors are dropping ever larger numbers of clients because of the risk of securities fraud litigation. "New companies, which have a particularly high chance of failure, are affected most, because almost nothing triggers lawsuits against accountants faster than company failures."[36]

The mere suggestion that this Court grant a petition to consider the possibility that reckless behavior does not give rise to Section 10(b) liability may raise substantial concern among advocates of an expansive reading of the federal securities laws. These concerns are, however, easily exaggerated.

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[35] *Central Bank*, 114 S. Ct. at 1454.

[36] Lee Berton, *Big Accounting Firms Weed Out Risky Clients*, Wall St. J., June 26, 1995, at B1.

The Securities and Exchange Commission's enforcement program will be largely unaffected by any ruling in this case because the Commission will remain able to attack reckless and negligent behavior in the sale of securities under Sections 17(a)(2) and (3) of the Securities Act of 1933. 15 U.S.C. § 77q(a)(2),(3).[37] Private party plaintiffs will also remain able to pursue defendants whose conduct evinces "a mental state embracing intent to deceive." Moreover, many defendants who have been charged with serious forms of recklessness that satisfy *Sundstrand's* objective and subjective standards are likely to find that their conduct will also support an inference of scienter under *Hochfelder.* Indeed, in the wake of *Central Bank*, the Securities and Exchange Commission made clear that it and private party litigants will continue to prosecute as primary violations of Section 10(b) certain forms of conduct that had been traditionally denominated as aiding and abetting.[38] This

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[37] Sections 17(a)(2) and (3) reach negligence and recklessness in the sale, but not in the purchase, of securities. *Aaron*, 446 U.S. at 697. Section 10(b) addresses fraud in both the purchase and sale of securities. A holding that recklessness is not sufficient for liability under § 10(b) might therefore restrict the Commission's ability to pursue fraud in the purchase of securities to cases involving scienter, not recklessness. It is difficult to conceive of realistic scenarios in which a party perpetrates a fraud through the reckless, non-scienter based purchase — not sale — of securities, and we are unaware of any such prosecutions in recent years. Concerns over the Commission's enforcement program therefore seem more theoretical than real. The Court could, however, limit even this remote consequence by basing its holding solely on the implied nature of the private § 10(b) right and reserving for a later case the question of whether recklessness suffices in Commission enforcement proceedings under § 10(b).

[38] *See, e.g., Concerning the* Central Bank of Denver *Decision Before the Subcomm. on Securities of the Senate Comm. on Housing and Urban Affairs*, 103d Cong., 2d Sess. (1994) (testimony of Arthur Levitt, Chairman, SEC), *available in* LEXIS, Legis Library, Cngtst file; Diana Henriques, *Towers Investors Try Aggressive New Legal Tack,*

Court expected and invited such a response when it observed that the "absence of Section 10(b) aiding and abetting liability does not mean that secondary actors are always free from liability under the securities acts," and that such actors could be found liable as primary violators, "assuming *all* of the requirements for primary liability under Rule 10b-5 are met." *Central Bank*, 114 S. Ct. at 1455. Plaintiffs and lower courts are acting as this Court anticipated, and primary liability under Section 10(b) is being attached to parties who have traditionally been pursued as aiders and abettors.[39]

A holding that limits Section 10(b) liability to scienter and establishes that recklessness does not suffice will therefore preserve plaintiffs' rights to attack conduct that evinces conscious fraud of the sort that Congress intended to proscribe under Section 10(b). It will also promote the judiciary's ability to filter out weaker claims that are unable to establish the essential elements of "knowing" or "intentional" misconduct under the federal securities laws. This is precisely the category of claims that should be thrown out of court as inconsistent with statutory language and legislative intent and prone to the danger of vexatious litigation giving rise to "blackmail settlements."

N.Y. Times, June 30, 1994, at D1; Tom Weidlich, *Professionals Still At Risk*, Nat'l L.J., July 18, 1994, at A6.

[39] *See, e.g., In re U.S.A. Classic Sec. Litig.*, No. 93 Civ 6667 (JSM), 1995 U.S. Dist. LEXIS 8327, at *13 (S.D.N.Y. June 19, 1995) (finding that plaintiffs' allegations were sufficient to establish primary liability and that the cause of action is not precluded by *Central Bank*). *See also* Edward Brodsky, *Aiding and Abetting Claims Under Rule 10b-5*, N.Y. L. J., June 14, 1995, at 3 (describing recent decisions in which traditional aiding and abetting activity has been attacked as a primary violation).

CONCLUSION

For the foregoing reasons, *amici curiae* request this Court to grant the petition for a writ of certiorari.

Respectfully submitted,

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In The

Supreme Court of the United States

October Term, 1995

MONTGOMERY SECURITIES and PAINEWEBBER, INC.,

Petitioners,

v.

RICHARD B. DANNENBERG, MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, trustees of William J. Bing and Arlene S. Bing Living Trust, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, and JACK SCHNITZER, On Behalf of Themselves and all others Similarly Situated,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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I. The Pressing Question of What Scienter Standard Applies Under Section 10(b) is Squarely Presented and is a Question That the Court Should Address.

Plaintiffs make four principal arguments why certiorari should not be granted on the question of what state of mind is required to impose liability in a private Section 10(b) claim. First, plaintiffs deny that there is any disarray among the lower courts as to the appropriate standard to apply. Opp. 8, 14-16. Second, even if there is such confusion, plaintiffs argue that the Court should not consider the question in this case, because the Ninth Circuit ostensibly found that the evidence was sufficient to support a finding not just of recklessness but of intentional fraud. Opp. 5, 6, 7-8, 10, 16. Third, plaintiffs argue that the question presented was not properly preserved below. Opp. 4, 7. Finally, plaintiffs assert that addressing the question is premature, either because Congress may enact legislation on the issue or because the case is at the summary judgment stage. Opp. 8, 14, 16-17.

For the reasons set forth below, none of these arguments provides grounds for denying certiorari.[1]

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[1] In their Opposition, plaintiffs also argued the merits, claiming that recklessness is sufficient to satisfy the mental state required under Section 10(b). *See* Opp. 11-14. Plaintiffs' analysis, however, requires only a limited response. To begin with, plaintiffs did not address the central issue, which is whether liability for recklessness is consistent with the language of Section 10(b), its legislative history, or the structure of the securities laws. Rather, their analysis is limited to the mental state required for common law fraud.

Even as to this point, plaintiffs simply repeat what this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and the Underwriters in their Petition, expressly recognized – namely, that recklessness was sufficient to prove fraud at common law "under some circumstances." *Id.* at 193 n.12; Pet. 12-13. The Underwriters showed in their Petition, however, and plaintiffs' own authorities confirm, that such "circumstances" were limited to *subjective* recklessness: the defendant had to know that it did not know whether the statement was true or false. Pet. 12-13; Opp. 12 n.4 (quoting *Lehigh Zinc & Iron Co. v. Bamford*, 150 U.S. 655, 673 (1893) (person must have been "conscious that he has no such knowledge")). The Ninth Circuit, however, does not require subjective knowledge to impose liability under Section 10(b). Its standard measures reasonableness, not dishonesty.

Plaintiffs attempt to slide over this critical distinction by arguing that subjective knowledge may sometimes be inferred from objective facts. Opp. 17-18. As the

1. Plaintiffs claim that it is "nonsense" to assert that there is any confusion among the lower courts on the scienter issue, and argue that the Courts of Appeals "uniformly" march to the same standard. Opp. 8, 14-16. In purporting to find such uniformity, however, plaintiffs stand alone. Unlike plaintiffs, commentators have found the caselaw in this area to be "largely incoherent,"[2] "too amorphous,"[3] "highly indeterminate,"[4] "deeply" split,[5] and "a veritable quagmire for the courts."[6] Unlike plaintiffs, the SEC likewise has found confusion and conflict among the circuits, and indeed has urged that all of the various standards utilized by the Courts of Appeals be rejected in favor of yet another approach.[7] And the courts themselves are acutely aware of the lack of coherence, even within the same Circuit. In *In re Leslie Fay Company Securities Litigation*, 835 F. Supp. 167, 172 & n.1 (S.D.N.Y. 1993), for example, the law within the Second Circuit is described as "indeed a murky area," with "confusion . . . so severe that it has resulted in conflicting opinions in the same case."

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seminal decision on deceit law observed more than a century ago, however, such an argument is fundamentally flawed: it involves "a confusion of unreasonableness of belief as evidence of dishonesty, and unreasonableness of belief as of itself a ground of action." *Derry v. Peek*, 14 App. Cas. 337, 352 (H.L. 1889) (Bramwell, L.). The common law required dishonesty, not merely unreasonableness, to sustain a cause. *Id.* This case squarely poses the question whether Section 10(b) liability can be imposed on a far lesser showing.

[2] Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. Cin. L. Rev. 667, 686 (1991).

[3] 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 84 (2d ed. 1990).

[4] James D. Cox, et al., *Securities Regulation: Cases and Materials* 740 (1991).

[5] Marc I. Steinberg & Samuel H. Gruenbaum, *Variations of "Recklessness" After Hochfelder and Aaron*, 8 Sec. Reg. L. J. 179, 181 (1980).

[6] Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986).

[7] *See* Brief of *Amici Curiae* at 12-13 & n.29.

Nowhere is the need for guidance from this Court more painfully apparent, however, than in the Ninth Circuit's gyrations on the subject. For years, different panels have adopted a variety of contradictory standards, including some that the court itself has acknowledged are "not clearly distinguishable from negligence." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (*en banc*) (citations omitted), *cert. denied*, 499 U.S. 976 (1991). The adoption in *Hollinger* of the standard from *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977), has not served to end the confusion. Indeed, the panel's adoption in this case of a negligence ("should have known") standard bears out the SEC's warning to the Ninth Circuit that *Sundstrand* is so ambiguous that it may be interpreted as requiring anything from mere negligence to heightened recklessness. *See* Brief *Amici Curiae* at 12 n.28.

In short, as one commentator summarized, "resolution of the availability of a recklessness standard, as well as a more explicit definition, must await Supreme Court determination." 2 Hazen, *supra* note 3, at 84. Until that time, it is likely that many courts, such as the Ninth Circuit here, will apply a standard "closer to negligence than the type of scienter that the Court in *Hochfelder* and *Aaron* might have had in mind." *Id.*

2. Even if there is confusion among the lower courts as to the proper standard to apply, plaintiffs contend that this is the wrong case in which to address the question, because the Ninth Circuit purportedly found the evidence against the Underwriters to be sufficient to support a finding of "deliberate fraud." Opp. 10. In making this argument, plaintiffs seemingly have fallen down a hole and emerged in a land where English words no longer have their ordinary meaning. Otherwise, the Court of Appeals could not have put its contrary conclusion any more plainly. It said with respect to the "only" Section 10(b) issues: "The plaintiffs presented *no* evidence of the Underwriters' actual knowledge or fraudulent intent on these issues." (A18) (emphasis added). The Court did not simply find that the evidence was insufficient – it found that there was not *any* evidence to support an inference of knowledge or deliberate fraud. That, of course, is what "no" means.

The Ninth Circuit's unambiguous conclusion is hardly surprising, inasmuch as plaintiffs did not even *claim* that the Underwriters had engaged in deliberate fraud, either in the district court or on appeal. In the district court, plaintiffs argued that the Underwriters had "actual knowledge" that "preliminary financial data was *available* for the June quarter" (emphasis added), but not that they had *seen* the information – only that they "should have" been suspicious and investigated further. (A40-41). Similarly, on appeal, plaintiffs asserted that "the accountants knew of the fraud,"[8] but only that the Underwriters should have known of it.[9]

The Ninth Circuit accepted plaintiffs' argument: it found that a reasonable jury could infer that the Underwriters "knew that Toolworks' financial data actually was available," "had access to" (not "had seen") this preliminary data, and therefore "knew, or should have known" of the alleged fraud.[10] (A15-16). The court did not, however, go on to find a supportable inference of deliberate fraud. Indeed, to do so would have been hopelessly inconsistent with the remainder of the court's opinion. For example, while finding a triable issue as to the Underwriters' diligence in investigating the preliminary June data, the court simultaneously found that the Underwriters were so diligent in investigating media allegations in June of slumping sales and improper accounting practices that no reasonable jury could find them even to have been negligent. (A14). Obviously, no one with an intent to defraud would

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[8] Appellants' Ninth Circuit Opening Brief at 18.

[9] "The underwriters, knowing that preliminary data for the crucial June quarter were available, did not ask for them, and made no effort to verify Toolworks' optimistic estimates to the SEC and the investing public. Instead, they blindly relied on management assurances." *Id.*

[10] Similarly, the "truth" that the Underwriters ostensibly might have helped to "conceal" was "that Toolworks' financial data actually was available." Because these results were themselves "optimistic," *id.*, plaintiffs have never suggested that their purported concealment would have assisted the fraud. Rather, plaintiffs' theory, which the Ninth Circuit's decision mirrors, is that if the Underwriters had attempted to verify these optimistic results, the fraud would have come to light. The complaint against the Underwriters thus is not that they were participants in the fraud, but that they should have uncovered it.

simultaneously pursue a diligent investigation that might well have revealed the fraud to others. The Ninth Circuit did not attempt to resolve this patent contradiction, but then it did not have to: it already had found "no evidence" of the Underwriters' knowledge or intent. (A18).

Finally, if the Ninth Circuit had held that the circumstances could support an inference of deliberate fraud, it would only have served to sharpen the conflict among the lower courts. Indeed, as the Underwriters showed in the Petition, courts have rejected even an inference of recklessness – much less deliberate fraud – on facts far stronger than those involved here. Thus, for example, in *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979), the court held that a factfinder might determine that inconsistencies in documents actually reviewed by (not just "available" to) the auditors "should have" led them to "ma[ke] further inquiry." Section 10(b) liability could not be imposed on such a basis, however, because it amounted to a theory of mere "negligence, which *Hochfelder* found insufficient."[11] *Id.* at 1200. In holding that a failure to investigate does support a Section 10(b) claim, the Ninth Circuit's conflict with other courts is clear, but understandable: as noted above, the Ninth Circuit in effect applies a negligence standard,[12] and hence it is not surprising that it would impose liability on this theory. To go yet further, and hold that these facts could show knowledge or intent, would exacerbate, not mitigate, the conflict on this question.

3. Plaintiffs next object that the Underwriters have not properly preserved the question presented. Plaintiffs' objection is not valid. To begin with, the Underwriters did in fact preserve the issues that are framed in the question. As noted previously, the Ninth Circuit addressed the scienter question *en banc* in *Hollinger*, and held that recklessness was sufficient under Section 10(b). *See* 914 F.2d at 1568-69. Because the panel was powerless to deviate from this *en banc* holding, the

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[11] *Accord* cases cited in Pet. 19-20 & n.16.

[12] *See, e.g., Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1449 (5th Cir. 1993) ("Insofar as Krim complains that 'BTX should have known' . . . he is claiming negligence").

Underwriters did not challenge this determination at the panel level. The Underwriters did, however, explicitly raise the issue of what form of recklessness should be required. Thus, the Underwriters urged the panel to follow *SEC v. Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992), and adopt a recklessness standard that requires a "lesser form of intent," rather than one that amounts to "mere negligence."[13] Brief for the Underwriter Appellees at 46.

In seeking rehearing of the panel's decision *en banc*, the Underwriters challenged the definition of recklessness adopted by the panel, *see* Underwriter Appellees' Petition for Rehearing and Suggestion for Rehearing *En Banc* at 5-11, and also raised the issue whether recklessness of any type is sufficient to impose liability under Section 10(b). On the latter point, the Underwriters argued that, under *Hochfelder*, "the existence of fraudulent intent is essential to a finding of liability under Rule 10b-5." *Id.* at 5. Given the panel's finding of no "actual knowledge or fraudulent intent," the Underwriters argued that the Section 10(b) claim had to be dismissed. *Id.* The question whether actual knowledge or intent, rather than mere recklessness, is required for liability under Section 10(b), thus was squarely before the Ninth Circuit.

Not only was the issue thus properly raised below, but policy considerations further support accepting review of the question presented. In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099 n.8 (1991), in deciding whether to consider an issue assertedly not raised below, the Court held that it is relevant to consider whether an issue is "in a state of evolving definition and uncertainty, and one of importance to the administration of federal law." (Citations omitted.) *Cf. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994) (resolving question of aiding and abetting liability after directing parties to address

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[13] The question was not only raised but passed upon by the panel. In rejecting the district court's conclusion that "should have" is "not the standard" required to show recklessness (A41), the Ninth Circuit specifically held that "knew, or should have known" is "sufficient to defeat summary judgment on the scienter issue." (A18).

issue). Here, both the uncertainty on the question and its importance are readily apparent. Section 10(b) litigation "demands certainty and predictability," *Id.* at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)), and the uncertainty of the governing rules, together with what this Court long has recognized as the unique danger of vexatiousness posed by such litigation, strongly support the grant of certiorari here.

4. Finally, plaintiffs' argue that the question is premature, either because Congress may legislate in the area, or because the case arises from a motion for summary judgment. Neither contention provides a persuasive basis for denying the Petition.

With respect to the possibility of a statutory amendment to Section 10(b), experience suggests that the likelihood that Congress will amend the statute to provide a definition of scienter is remote. Indeed, in the nearly half-century that Section 10(b) has been found to provide a private right of action, Congress repeatedly has amended the securities laws without addressing what mental state is required to establish a Section 10(b) violation.[14] If, as seems likely, past is prologue, this legislative session likewise will end without any legislative definition of Section 10(b) scienter. Given the importance of the scienter question to those who participate in the country's capital markets, and the uncertainty and unpredictability of the present rules for determining liability, surely fifty years of waiting for Congress to act is enough, and securities professionals, companies, and their investors are entitled to a definitive resolution of the scienter question.[15]

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[14] As plaintiffs correctly point out, the House recently passed a bill that would provide a definition of Section 10(b) scienter. *See* H.R. 1058, 104th Cong., 1st Sess. § 4 (1995) (Mar. 12, 1995). Legislation enacted by the Senate, however, specifically avoids providing any definition of the mental state required to make out a Section 10(b) violation. *See* S. 240, 104th Cong., 1st Sess. § 104(b) (June 28, 1995).

[15] As *Amici curiae* pointed out in their supporting brief, even if Congress were to enact legislation, there are hundreds of cases presently pending (and involving billions of dollars of potential liability) that would not be reached by such legislation. *See* Brief of *Amici Curiae* at 4 n.3.

Finally, the procedural posture of the case counsels in favor of, rather than against, the granting of the Underwriters' Petition. Because this case arises on a motion for summary judgment, there are no factual questions that might prevent the Court from reaching the purely legal question of what scienter standard should be adopted.[16] Nor is the question peripheral to the resolution of this litigation. To the contrary, because the Ninth Circuit has found no evidence of the Underwriters' actual knowledge or intent, a trial is unnecessary unless recklessness is enough. Similarly, if the Court finds that recklessness suffices under Section 10(b), but adopts a subjective standard, the claim against the Underwriters would have to be dismissed, or at a minimum remanded for consideration by the Ninth Circuit under the higher standard.[17]

II. The Second Question Also Merits the Court's Review.

It is a measure of the weakness of plaintiffs' opposition to a grant of certiorari on the second question that their brief is devoted almost entirely to an issue that the Ninth Circuit did not reach, and that this case accordingly does not raise. Plaintiffs' opposition, which goes so far as to rewrite not just the Ninth Circuit's decision but even the Underwriters' Question Presented, thus warrants only an abbreviated response.[18]

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[16] Indeed, the Court recently used a case in which the lower court had granted summary judgment to resolve the analogous issue in civil rights litigation of what mental state is required to show "deliberate indifference." *See Farmer v. Brennan*, 114 S. Ct. 1970, 1973 (1994).

[17] Plaintiffs' argument that subjective recklessness or knowledge always can be inferred from objective circumstances (Opp. 16-18) proves far too much, and taken to its logical conclusion would preclude the granting of a motion to dismiss or for summary judgment. In fact, however, cases often are disposed of by motion for failure to plead or prove facts that could sustain an inference of scienter. *See, e.g., Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2d Cir. 1994) (affirming dismissal for failure to strong inference of scienter); *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1449-50 (5th Cir. 1993) (affirming summary judgment on scienter).

[18] The Underwriters have challenged the Ninth Circuit's reversal of the entry of summary judgment on both plaintiffs' Section 11 and Section 12(2) claims. *See* Pet. i. Plaintiffs have rewritten the question to apply only to Section 11. *See* Opp. i.

Section 11 and Section 12(2), both of which plaintiffs alleged as the basis for claims against the Underwriters, prohibit the use of statements that are rendered misleading by the omission of a material fact. Section 11, as the Underwriters pointed out in their Petition, also prohibits the omission of a material fact "required to be stated." (Pet. 24 n.19) Section 12(2), however, contains no such provision. Whether an omitted fact was "required to be stated," therefore, provides no basis for avoiding summary judgment on a Section 12(2) claim. The only basis for sustaining an "omission" theory under Section 12(2) is that it rendered misleading some affirmative statement that was made.

In its decision, the Ninth Circuit addressed plaintiffs' Section 11 and Section 12(2) claims together, from the first sentence of its analysis ("[w]e first address the plaintiffs' claims against the Underwriters under Sections 11 and 12(2) of the 1933 Act"), to the last ("[w]e remand for a trial on the merits of those [Section 11 and 12(2)] claims"). (A4, A16) Given its combined treatment, the Ninth Circuit's analysis, not surprisingly, was directed exclusively at the theory that would sustain liability under both statutes, namely, the omission of facts that would render a statement misleading. The Ninth Circuit was explicit on the point. In rejecting the Underwriters' argument that post-prospectus events could not provide a basis for liability, the court stated:

> The Underwriters' contention that the events of this period are inapplicable to Sections 11 and 12(2) liability is clearly incorrect. *Both statutory provisions* require disclosure of information needed in order to make a prospectus truthful and not misleading.

(A13 n.2) (emphasis added).

Contrary to plaintiffs' assertions, the decision thus was plainly based on the ground applicable to "both" statutory provisions. Plaintiffs' "required facts" argument, to which plaintiffs devote the great bulk of their opposition, *see* Opp. 18-21, was never reached by the Ninth Circuit. At most it would provide a basis for remanding the Section 11 claim to the Ninth Circuit after reversal, so that the Ninth Circuit could

decide, in the first instance, whether to follow the district court decisions which have rejected plaintiffs' "required facts" theory under Item 303 of SEC Regulation S-K.[19]

As to that issue, plaintiffs have virtually nothing to say. Plaintiffs fail effectively to rebut the Underwriters' showing that the Ninth Circuit's decision is in conflict with the text of Section 11 and Section 12(2), with their legislative history, and with the decisions of other lower courts both under the 1933 and 1934 Acts. They also pass over in silence what the Underwriters demonstrated would be the potentially severe chilling effect of the Ninth Circuit's rule on the ability of companies to engage in public offerings for several months out of each year. Plaintiffs' sole argument is to engage in a *reductum ad absurdum* of the language of both Sections 11 and 12(2), by which their requirement of an affirmative "statement" that the omission renders misleading effectively is written out of the statute books.

CONCLUSION

For all of these reasons, certiorari should be granted.

Respectfully submitted,

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[19] *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1053 (9th Cir. 1993) (alleged failure to comply with Item 303 is not § 11 violation); *Anderson v. Clow*, [1993 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807, at 97,989 (S.D. Cal. Sept. 17, 1993) (Item 303(a) applies only to reports filed on Form 10-K, and "omitting Item 303(a) information from a Prospectus does not violate § 11").